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TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

Vol 3

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Techniques of Investigation for Assessment

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Foreword

In the rapidly changing economic scenario, where the economic transactions are happening across the borders and becoming more and more complex by the day, the tax authorities are required to keep themselves updated on the important developments in various trades and industries. The latest information on the cutting-edge developments in various sectors of economy are a must for the tax investigators. Therefore, a need was felt to revise the write-ups on various important, as well as upcoming sectors of economy, as a lot of changes have occurred since the existing *'Manual on Techniques of Investigation'* was last released in the year 2002.

Two volumes (i.e. Volume 1 and 2) of the Manual have already been revised. Volume 3 and 4 of this Manual have also been updated now.

Volume 3 covers twenty industries and trade, encompassing conventional manufacturing, hospitality and services industry. The impact of introduction of GST and GST related tax evasion has been discussed in relevant chapters. The use of Tally and ERP software for tax evasion has also been explained with examples in the chapter 'Engineering Industry'. Further, tax-related issues arising in Joint Ventures with foreign multi-national corporations and foreign manufacturers, the TP issues, analysis of segment wise performance have also been discussed in the chapter 'Automobile Industry'. The tonnage scheme and the issues involved in international shipping companies have been incorporated in the Chapter on 'Shipping Industry'.

Volume 4 contains write-up on ten sectors of industry and economy including multi-national corporations, information technology companies, e-Commerce, broadcasting and television industry, event management & advertisement industry. The contemporary tax related challenges pertaining to these sectors of industry have been discussed in a nuanced manner.

I would like to reiterate my special appreciation for the efforts of all the members of the Committee and other officers associated with the enormous task of updating and writing this Manual. I hope that these Volumes shall be able to meet the expectations of all the stakeholders and would act as a guiding light while conducting tax-related investigations.

New Delhi
Dated: 09/09/2019

(Pramod Chandra Mody)
Chairman and Member (Investigation)[i/c]
Central Board of Direct Taxes

Preface

The Board had constituted a Committee on 27.11.2017 to review and update the departmental publication of "*Techniques of Investigation Manual*" (Vol. 1 to 5) 2002. The Committee had decided to bring the manual in seven volumes. The first two volumes had introductory and general chapters whereas the rest of the volumes would cover specific business/ industry wise write-ups. The work involved re-writing the existing chapters incorporating the changes undergone in last sixteen years and also including many new chapters. The Volume 1 & 2 was presented to the Chairman, CBDT in the month of December, 2018. The Volume 1 had dealt with general issues arising in tax administration, investigation & examination of accounts for the purpose of drafting good assessment orders etc. However, all the topics of Volume 2 were new covering TP&IT issues, Black Money Act, PMLA, GST, Investigation of undisclosed foreign assets, Accommodation entries, Penny stock & shell companies, Digital Evidence and Forensic, Bitcoins & Cryptocurrencies, NCLT, Commodity, Money and Currency Market etc.

The Committee has great pleasure in now bringing out the Volume 3 of the Manual. This volume incorporates write-up on twenty industries and trade, identical with the second volume of 2001 edition, except that topic 'Computer Training Institutes' has been excluded. As the computer training has now become part of basic curriculum and the essential features of this sector is already part of 'Educational & Coaching Institutes', this separate write up has been done away with.

As the basic concepts and process of the industries have not undergone change, we have Utilised the material available in the earlier volume. At the same time there is value addition to them taking into account the new processes and the new issues in avoiding or evading the taxes. Most of the topics have been revised incorporating the refinements undergone in old methods and incorporating the changes in the statute and the procedures. The recent judicial pronouncements on the relevant topics have also been incorporated.

In the chapter 'Engineering Industry' the impact of GST has been discussed in detail, incorporating the accounts to be maintained and various returns to be filed under GST. Further, use of Tally and ERP software for tax evasion has also been discussed in detail and explained with examples. The GST related tax evasion having impact on income has been discussed in the chapter 'Handloom and Powerloom'. The 'e-way billing' pursuant to GST and coordination with the GST authorities in this regard has been included in the 'Road Transport'. The scope of the topic 'Hosiery Industry' has been widened by including all kinds of fabric, in place of only woollen fabric discussed in earlier volume.

The concept of benchmarking of various ratios of the industry as a whole vis-a-vis those of Indian manufactures, JV with foreign MNC and foreign manufactures has been discussed in the chapter 'Automobile Industry'. Further, the TP issues in automobile sector, investigation of AMP and analysis

of segment wise performance has also been discussed. In the 'Power and Energy' sector; the recent trends, key challenges of the sector and various taxation issues have been discussed in great detail. The issues of applicability of MAT as well as international taxation and TP issues have also been dwelt upon in this chapter.

The tonnage scheme and the issues involved in international shipping companies have been incorporated in 'Shipping Industry'. Similarly, the profession of Sports professionals and Painters, Sculptors & Fine Artists has been included in 'Other Professions'. The manipulation of computerized accounts in the case of standalone restaurants detected in the course of search and surveys has been supplemented in 'Hospitality Industry'. In the chapter on 'Charitable Trusts and Institutions' the recent changes in the nature of charitable activity and the various issues involved in the registration and assessment of Trusts are discussed in great detail. The issues pertaining to trusts and societies, which run the educations institutes, have been focussed upon in the chapter 'Educational and Coaching Institutes'.

We hope that the material compiled in this volume will provide necessary guidance and help to the Officers and will be a reference point for times to come. The Committee acknowledges the effort of all the officers who have contributed and made value addition for compilation of this Volume. We are thankful to the Editorial Board for going painstakingly through the write-ups and for their valuable inputs.

N.P. Sinha
Chairman of the Committee

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CHAPTER

1

Engineering Industry

1. INTRODUCTION

1.1 According to Webster's dictionary (1961 Edition), the word 'Industry' means (i) systematic labour especially for the creation of value, (ii) a department or branch of craft, art, business or manufacture, a division of productive and profit-making labour especially one that employs a large personnel and capital in manufacturing, and (iii) a group of productive or profit making enterprises or organisations that have a similar technological structure of production and that produce or supply technically substitutable goods, services or sources of income. This definition has been referred to by the Hon'ble Supreme Court in the case of *Harakchand Ratanchand Banthia* vs. *Union of India 1969* (SCC) 166.

1.2 Industrial Sector: Industrial sector consists of five sub-sectors as under:

a. Procurement and processing of raw material

b. Manufacturing and production

c. Mining and quarrying

d. Electricity, energy, gas and water supply

e. Engineering Industry

1.3 Source of Output/ Value Added Data: There are five distinct sources of output/ value-added data of the industrial sector**:**

a. NAS National Accounts of Statistics: compiled and published by Central Statistics Organisations

b. IIP Index of Industrial Product: prepared by Department of Industries (Govt. of India)

c. ASI Annual Survey of Industries: Governmental Survey

d. RBI Bulletins Published by Reserve Bank of India after survey of Industries.

e. **CMIE** Surveys of different Industrial sectors published by Centre for Monitoring Indian Economy.

1.4 Production Process: It is necessary for an AO to have an overview of the production process, for being able to make basic judgments of the various claims being made before him. For this, he must have information on the following points:

a. Product types, varieties
b. Manufacturing process
c. Number and levels of workers involved in manufacture
d. Input-output ratios
e. Capital investment per unit of production of main items
f. Physical measures/ value of output, installed capacity and its utilisation, etc.
g. Type/ level of technology/ automation.
h. Profitability ratios.

2. ENGINEERING INDUSTRY

2.1 Engineering Industry has a very wide reach and coverage in terms of the variety of products, the level of technology, the size/ capacity, geographic dispersal, and levels of employment potential. Some of the main products of this Industry are:

a. Electric motors
b. Automobile and auto parts manufacturing machines
c. Hand tools manufacturing machines
d. Mathematical instruments
e. Locomotive machineries
f. Machinery related with ships and aircrafts
g. Bicycles, motorbikes and auto cycles
h. Auto Rickshaws, tempos etc.
i. Boilers and steam generating plants
j. Steam engines, turbine and internal combustion engines
k. Electrical machines and appliances manufacturing machines
l. Tele-communication equipment machinery
m. Radio and electronic equipment machinery
n. T.V., A.C, refrigerator, wireless, mobile phone manufacturing machines
o. Electric wire and cable producing machines
p. Machines used for production of bolts, nuts, rivets and washers
q. Jute, textile and netting machinery
r. Batteries manufacturing machines
s. Railway coaches and wagons manufacturing machinery
t. Mechanical pumps machinery
u. Earth moving machinery
v. Harvester machinery
w. Bright steel bars and shafting machinery
x. Steel melting works machinery
y. Steel rolling mills machinery
z. Household goods manufacturing machines
aa. Power-driven pumps

The National Industrial Classification Code 1998 (NIC) gives descriptive classification of groups, class, sub-class of engineering Industries. This is available in the market, under Central Excise Classification/ Valuation publications. Basically, the Engineering enterprises are classified as Heavy engineering enterprises and Light engineering enterprises.

2.2 Heavy Engineering Enterprises: Heavy engineering enterprises are basically industries producing machines, heavy vehicles, motors, etc. For example, Larson and Toubro, Bharat Heavy Electricals Ltd., Hindustan Aeronautical Ltd., Bharat Engineering Works, Hindustan Machine tools. These are capital intensive, their ownership patterns vary and their gestation periods are large. They can be in Public or Private sector.

2.3 Light Engineering Enterprises: Light engineering enterprises are mainly those industries which produce common consumer/ engineering goods, with or without sophisticated technology. These can be industries producing marketable products with independent manufacturing units,

or ancillary industries dependent upon other big industries manufacturing engineering machinery, goods, etc. Some examples of these are:

a. Watch manufacturing units
b. Rerolling units
c. Steel rods and sheets manufacturing units
d. Metal Box industry
e. Container manufacturing units
f. Bucket producers
g. Hurricane lanterns manufacturers
h. Stove manufacturers
i. Cycle and automobiles parts manufacturers
j. Bearing manufacturers
k. Small pumps producers
l. Hand set pump producers
m. Diesel oil engine manufacturers
n. Sheet metal parts manufacturers
o. Rubber based industries
p. Plastic components manufacturers
q. Small industrial machinery and parts manufacturers

3. MANUFACTURING PROCESS

3.1 Raw Materials: Engineering industries include a large number of industries, producing a variety of goods. The exact raw material used by a particular industry will depend upon the finished goods it is producing and the technology it is using. Therefore, it is necessary to ascertain the particulars of the raw materials being used and the source of their supply in a given case. A broad classification of the engineering industries, in terms of their finished products can be as under:

a. Industries using basic metals, alloys and steel products.
b. Industries using tin plates, tin bars, galvanized plates, & iron sheets.
c. Industries using nonferrous metal and alloys.
d. Industries using copper, zinc and lead.
e. Metal products industries, like producer of wire nails, nuts, bolts, spanners, utensils, razor blades, wire ropes.
f. Non-electrical machinery industries which produce machines for mining, cotton textile, jute mills, sugar mills, cement, pulp and paper, earth movers, tractors, machine tools, typewriters, calculators, sewing machines, ball bearings, compressors, batteries etc.
g. Industries which manufacture electric machinery, appliances, instruments etc., switch gear and control gear, transformers, electric fan, electric lamp, electric motor, electric wires and cables.
h. Electronic industries which include manufacturers of radio sets, photo camera, X-rays machine, sonography machine, T.V. sets, mobile phone sets, wireless, transmitters, computer and related equipments.
i. Transport equipment manufacturing industry, which includes the automobiles industry-cars, trucks, three wheelers, two wheelers, buses, motorcycles, cycles and their equipments and parts.
j. Other industries, manufacturing items like watches and clocks, house service meters, scientific instruments, surgical instruments, asbestos brake lining, grinding wheels etc.

The basic raw materials and components are procured from definite sources which might be a steel plant, an aluminum plant or other large plants making various grades of metals. At times these raw materials are procured from open market from traders. The quantity details of the consumption of raw material and its opening

and closing Stock can be available if records are maintained methodically. The range of wastage and process losses in a particular type of Light Engineering Industry can be determined and compared with other units in the same line of business using similar raw material and technology.

3.2 Manufacturing: It is essential for an AO to have full knowledge of the manufacturing process in a given case. Without this, he will not be able to judge the reasonableness of the production results, yield, burning losses, shortages and the input: output ratio. Some of the heavy engineering Industries involve complicated manufacturing process. Similarly, some light engineering industries may also have complex activities of manufacturing. There would not be a common manufacturing process because of the varieties of the industries and their products. However, some steps of manufacturing process may be common. An Assessing Officer will have to comprehend full details of manufacturing process in a given case. While going through the whole process one has to be clear about the technology and quality of machinery used by the assessee. If a manufacturing unit employs latest technology using sophisticated manufacturing process, it would be able to process the raw material and consumables in a more efficient way giving better production in terms of quantity as well as quality, as compared to a unit which employs a labour-intensive, out dated technology or older technology. The exact manufacturing process will vary from industry to industry. An overview of the manufacturing process in some of the major engineering industries is given in succeeding paragraphs.

4. ELECTRIC MOTORS

4.1 Electrical motors can be either of DC type or AC type. The AC motors can also be either single phase or three phase. Single phase AC motors can again be of several different types, depending upon their usage, as under:

a. **Split-Phase:** Owing to their high starting currents, split-phase motors are generally used for loads of low inertia and frequent starting. Where a higher starting current can be tolerated, motors of the higher torque rating can be used.

b. **Capacitor-Start Induction-Run:** These motors, having higher starting torques and low starting currents than split-phase motors, are more suitable for loads of higher inertia and more frequent starting.

c. **Capacitor-Start Capacitor-Run:** These motors have characteristics similar to capacitor-start induction-run motors, but are useful when greater degree of quietness or a higher efficiency and power factor are desired.

d. **Capacitor-Start and Run:** These motors are useful where low starting torques are acceptable. They are also generally quieter than split-start induction-run motors.

e. **Shaded-Pole:** These motors are suitable for all applications where only very low starting torque is required and motor efficiency is unimportant.

f. **Universal:** These motors are series-wound or compensated series-wound, which may be operated either on direct current or single-phase alternating current at approximately the same speed and out-put, and are suitable for applications where speeding up on light loads is desirable. In these motors, it is possible to get gradually high speed. Therefore, they are suitable for domestic mixers, grinder juicers, sewing machines, domestic mono-block pumps etc.

Capacitor-start Induction-Run, and Capacitor-Start Capacitor-Run motors are mainly used by the cottage industries, for domestic mono-block pumps, domestic grinders, washing machines, air conditioners, exhaust fans, bore-well pumps, cooking Chula, water cooler, air cooler, refrigerator, etc.. Due to such wide applications, there is big market of these motors. Indian Standard specifications for single phase small AC

and Universal Electric Motors IS: 996–1964 have been issued by Indian Standard Institution. Testing guide lines, 7572–1974 are also published by the ISI. Separate publications are also published by the ISI for special purpose motors.

4.2 There are three main types of 3-Phase motors, *viz.*-Squirrel Cage Induction Motors, Slipring Electric Motors, Synchronous Electric Motors. These have their own advantages and disadvantages. Industries select the motors as per their applications/ sustainability. SSI Units manufacture mostly upto to 10 HP motors. Motors below 10 HP are mainly in Squirrel cage only. The Squirrel cage motor has two main parts, i.e. stator and rotor. These are made from laminations (stampings). The stator has 24 to 36 slots. Depending upon the requirements of speed of motor, manufacturers wind the stators with enameled copper wire. These motors are made of copper bars threaded through slots in a laminated rotor core, with their ends short-circuited with short ring. Some manufacturers use aluminum die cast rotor. Generally, most of the SSI units procure these die cast from lamination manufacturer or get these made on job basis from die cast industries.

4.3 The various stages involved in manufacture of motors can be listed as under:

a. Casting enclosures of motor with the help of patterns.
b. Machining of motor body.
c. Machining of motor side cover.
d. Machining of motor shaft.
e. Machining of motor shaft-rotor.
f. Grinding of motor shaft-rotor.
g. Drilling all parts of enclosures.
h. Binding stator lamination on press.
i. Fixing of stator inside body on press.
j. Winding coil from super enameled wire.
k. Cutting the insulation paper.
l. Fixing insulation paper in slot of stator.
m. Inserting coil in stator slots.
n. Winding coil connection.
o. Winding pre-heating at 120 C in oven for 1 hr.
p. Winding high voltage insulation test.
q. Winding varnishing.
r. Varnish curing in oven at required temperature.
s. Fixing bearings on shaft.
t. Assembling the motor.
u. Routine or type testing of motor.
v. Terminal connections.
w. Colour processing
x. Registration and labeling.

5. CENTRAL AIR CONDITIONING PLANTS

Central air conditioning plants comprise of compressors, condensers, air-handling units, water chillers and cooling towers. It also includes pumps, gauges, ducts, and cables. The compressors used in vapour compression plants are of three types:

a. Reciprocating Compressor.
b. Screw Compressor.
c. Centrifugal Compressor.

All or some of these parts may be manufactured in-house, and remaining purchased from outside sources for assembling.

6. BATTERIES

Battery is a power generating device which converts stored chemical energy into work of an electrical nature. There can be Primary batteries (which are not rechargeable, and are used in electronic equipments); and, Secondary Batteries (which are electrically rechargeable, eg., Lead Oxide and Nickel Cadmium).

7. BEARING INDUSTRY

7.1 Bearing industry has grown up substantially in Saurashtra, North India and Bangalore region. Bearings facilitate the relative motion of metal surfaces in contact, with limited consumption of energy. This lowers the friction and thereby the energy required. The roller bearings consist of an inner ring, an outer ring, a cage, and rolling elements. Roller bearings are divided according to the type of the roller as under:

a. Taper Roller Bearings

b. Cylindrical Roller Bearing

c. Needle Roller Bearings

d. Spherical Roller Bearings

7.2 Roller bearings are different from ball bearings. Ball bearings have higher limiting speeds than roller bearings. Manufacturing of bearings comprises of following stages:

a. Inner recess

b. Outer recess

c. Rollers

d. Cages

e. Assembly, and

f. Technical inspection

Inner recess involves face grinding, large outer-grinding, bore-grinding, side-cut rough grinding, side-cut finish grinding, track rough/ finished grinding, dimensional and visual assembly. At the time of final assembly, a technical inspection is made to check the bore and outer dimensions; the height of Taper roller bearing; the radial run of outer race with reference to stationary inner race; and, the perfection of contact angle between rolling elements and the recess.

8. GEARS

Earlier most of the gear manufacturing machines were based on conventional technology but now gear engineering and gear motors manufacturers have switched over to CNC versions. The latest CNC version machines are being imported, and work on 3-axis control. Now-a-days "zero error" gear motors are being manufactured which need higher kinematics.

9. CONTROL OF VARIOUS GOVERNMENT DEPARTMENTS

9.1 Various engineering industries come under the statutory control of various different departments, e.g., GST, Pollution Control, Factory Inspector, Industries, Labour, Consumer, Weights & Measures, Electricity Boards, Fire safety, etc. Besides, they have dealings with banks and financial institutions.

9.2 Information furnished to these departments can be a good source for the AO. For example, an industrial gas producing unit might be disclosing a lower yield ratio in its books, whereas in the project report submitted to the Pollution Control Department or Energy Department or District Industry Centre, it might disclose the actual yield. The yield factor is part of Form 3CD, both for trading and manufacturing concerns. This can be cross-checked with various other sources or technical journals and project reports pertaining to the specific Industry. Burning loss can be compared with the average burning loss from reputed journals. Scrap generated is also closely related to the consumption process as the scrap is generated in the production process. Many industries do not report the scrap or contend that these have no value. This may need further investigation.

9.3 Similarly, information given to banks may be materially different from that given in the books of accounts. The industries regularly hypothecate the stock for procuring working capital or fixed assets. This is an important source for ascertaining the stock at a particular point of time and the stock so ascertained can be matched with the stock as per books. This may result in detection of undisclosed production or out-of-books sale, particularly when detailed stock statement is provided to the Bank.

9.4 Electricity consumed: Engineering industries consume substantial electricity. It has come to light in many cases that the day-wise electricity consumption figure varies abruptly with respect to corresponding production figures. This may happen where books are back-dated and are also pointers to out-of-books production and sale. This aspect should be closely scrutinised, which may yield substantial results in certain industries like casting, blast furnaces etc.

9.5 Industrial Laws Applicable to Engineering Industries: Engineering industries are subject to several important industrial legislations relating to safety, labour welfare, consumer welfare, quality control, etc. Sometimes actions under these laws by the concerned departments can give important clues to the Assessing Officer. Some of these central laws are as under:

a. Laws Relating to Industrial Relations

(i) Industrial Disputes Act, 1947

(ii) Trade Unions Act, 1926

b. Laws Relating to Wages

(i) Minimum Wages Act, 1948

(ii) Payment of Wages Act, 1936

(iii) Payment of Bonus Act, 1965

c. Laws Relating to Social Security

(i) Employees' Provident Funds and Miscellaneous Provisions Act, 1952

(ii) Employees' State Insurance Act, 1948

(iii) Labour Welfare Fund Act (of respective States)

(iv) Payment of Gratuity Act, 1972

(v) Employee's Compensation Act, 1923

d. Laws Relating to Working Hours, Conditions of Services and Employment

(i) Factories Act, 1948

(ii) Industrial Employment (Standing Orders) Act, 1946

(iii) Shops and Commercial Establishments Act (of respective States)

(iv) Contract Labour (Regulation and Abolition) Act, 1970

(v) Inter-State Migrant Workmen (Regulation of Employment and Conditions of Service) Act, 1979

(vi) Weekly Holiday Act, 1942

(vii) National and Festival Holidays Act (of respective States) 1963

(viii) The Plantation Labour Act, 1951

(ix) The Mines Act, 1952

(x) The Dock Workers (Safety, Health & Welfare) Act, 1986

***e.* Laws Relating to Equality and Empowerment of Women**

(i) Equal Remuneration Act, 1976

(ii) Maternity Benefits Act, 1961

f. Prohibitive Labour Laws

(i) Bonded Labour System (Abolition), Act, 1976

(ii) Child Labour (Prohibition & Regulation) Act, 1986

(iii) The Beedi and Cigar Workers (Conditions of Employment) Act, 1966

(iv) The Sexual Harassment at the Workplace (Prevention, Prohibition and Redressal) Act, 2013

g. Laws Relating to Employment and Training

(i) Apprentices Act, 1961

(ii) Employment Exchanges (Compulsory Notification of Vacancies) Act, 1959

9.6 Most of these laws have a direct relevance for the assessment proceedings. For example, Factories Act 1948 imposes certain obligations and responsibilities on the occupier of factory. As per Section 7 of this Act occupier shall, at

least 15 days before he begins to occupy or use any premises as a factory, send to the Chief Inspector a written notice containing name and situation of factory, name and addresses of occupier and owner of the premises, nature of the manufacturing process carried on in the factory, total rated horse power installed in premises, name of the manager of the factory, number of workers likely to be employed, average number of workers per day employed and other particulars. This information submitted to the competent authority is relevant for assessment proceeding. There may be a situation that factory has already been started but return of income is filed later concealing the date of start of manufacturing process or completion of project or installation of plants etc. The actual date of start of operation can be ascertained for the purpose of deduction *u/s* 10 or *u/s* 80I, which is often in dispute. An AO can find out the date of actual installation of the plant and machinery, where there is dispute about claim of depreciation. Again, *u/s* 62 of the Factories Act 1948 manager of the factory has to maintain register of adult workers, which can be scrutinised to check the correctness of the claims of expenditure on salary or wages. *U/s* 110 of Factories Act, the manager, occupiers or owners of the factory have to submit returns periodically to the concerned authority, which can be a source of information for the AO. The registers maintained also throws light on the items in the closing stock, besides the use of raw material etc. in the production process. Similarly, information submitted under the Payment of Bonus Act, Payment of Gratuity Act, and Employees Provident Funds Act 1952, can become important source for an AO.

9.7 The Ministry of Labour and Employment, Government of India has notified the Ease of Compliance to Maintain Registers under various Specified Labour Laws Rules 2017 (Ease of Compliance Rules). The Ease of Compliance Rules enables an employer to maintain 5 (five) types of combined registers under the following labour laws:

a. Building and Other Construction Workers (Regulation of Employment and Conditions of Service) Act 1996;

b. Contract Labour (Regulation and Abolition) Act 1970;

c. Equal Remuneration Act 1976;

d. Inter-State Migrant Workmen (Regulation of Employment and Conditions of Service) Act 1979;

e. Mines Act 1952;

f. Minimum Wages Act 1948;

g. Payment of Wages Act 1936;

h. Sales Promotion Employees (Conditions of Service) Act 1976; and

i. Working Journalists and Other Newspaper Employees (Conditions of Service) and Miscellaneous Provisions Act 1955,

(collectively referred to as the Specified Labour Laws).

The 5 (five) types of combined registers required to be maintained under the Specified Labour Laws, include:

a. Employee Register;

b. Wage Register;

c. Register of Loan/ Recoveries;

d. Attendance Register; and

e. Register of Rest Days/ Leave account of employees/ Leave with Wages.

The format of employee register contains different entries, e.g. Employee Code, Name, Surname, Gender, Father's/ Spouse Name, Date of Birth, Nationality, Education Level, Date of Joining, Designation, Address, Type of Employment, Mobile, UAN,PAN,ESIC, IP, AADHAAR, Bank A/c Number Bank etc. All these information may come in handy in ascertaining actual labour/ employee expenses. Labour charges/ employee expenses are substantial in manufacturing/ construction industries. One should verify the

muster rolls/ wage register and other related registers maintained under Factories Act, Labour laws etc. Corresponding compliance with PF/ ESIC Act also needs to be verified to ensure that no bogus amounts are claimed.

10. GOODS & SERVICES TAX

10.1 Goods & Services Tax Law in India is a **comprehensive**, **multi-stage**, **destination-based tax** that is levied on every **value addition**. In simple words, Goods and Service Tax (GST) is an indirect tax levied on the supply of goods and services. This law has replaced many indirect tax laws that previously existed in India. GST is **one indirect tax** for the **entire country**. GST is an Indirect Tax which has replaced many Indirect Taxes in India. The Goods and Service Tax Act was passed in the Parliament on 29th March 2017. The Act came into effect on 1st July 2017.

10.2 Under the GST regime, the tax is levied at every point of sale. GST is applicable on each value addition to the product. GST has thus removed the cascading effect as the tax is calculated only on the value-addition at each stage of the transfer of ownership. For example a manufacturer who makes bearings buys steel and other consumables. Assume that the cost of raw material is Rs. 400 including tax @10% of Rs. 40. The value of the input materials increases as the bearing is manufactured.The manufacturer then sells it to the wholeseller for Rs. 500 with a margin of Rs. 100. The tax @ 10% comes to 50 but since he has already paid Rs 40 on input items, therefore, he is required to pay only Rs. 10 extra. The wholeseller packs required number of bearings in packs and labels it with further addition of value after which he sells it to the retailer. Let us assume that he sells the goods to retailer at Rs. 600. He has to pay tax @ 10% at Rs. 60 but since he has already paid tax of Rs. 50, therefore, he needs to pay only Rs. 10 extra. The retailer may package the bearings in smaller quantities as per orders and also invests in the marketing and promotion of the product thus increasing its value. He may sell the goods to the end comsumer at Rs. 700. The tax to be paid @ 10% is Rs. 70. but since he has already paid Rs. 60, he needs to pay only Rs 10/- extra. The total tax levied, therefore, comes to Rs 40+10+10+10= 70/-.

10.3 There are 3 taxes applicable under this system: CGST, SGST & IGST.

a. **CGST:** Collected by the Central Government on an intra-state sale (eg: within Maharashtra)

b. **SGST:** Collected by the State Government on an intra-state sale (eg: within Maharashtra)

c. **IGST:** Collected by the Central Government for inter-state sale (eg: from Maharashtra to Tamil Nadu)

In most cases, the tax structure under the new regime will be as follows:

Transaction	New Regime	Old Regime	
Sale within the State	CGST + SGST	VAT + Central Excise/ Service tax	Revenue will be shared equally between the Centre and the State
Sale to another State	IGST	Central Sales Tax + Excise/ Service Tax	There will only be one type of tax (central) in case of inter-state sales. The Centre will then share the IGST revenue based on the destination of goods.

10.4 The following is the list of indirect taxes in the pre-GST regime which has been replaced by CGST, SGST, and IGST:

a. Central Excise Duty

b. Duties of Excise

c. Additional Duties of Excise

d. Additional Duties of Customs

e. Special Additional Duty of Customs

f. Cess
g. State VAT
h. Central Sales Tax
i. Purchase Tax
j. Luxury Tax
k. Entertainment Tax
l. Entry Tax
m. Taxes on advertisements
n. Taxes on lotteries, betting, and gambling

However, the chargeability of CST for Inter-state purchase at a concessional rate of 2%, by issue and utilisation of C-Form is still prevalent for certain Non-GST goods such as:

a. Petroleum crude;
b. High-speed diesel;
c. Motor spirit (commonly known as petrol);
d. Natural gas;
e. Aviation turbine fuel; and
f. Alcoholic liquor for human consumption

in respect of following transactions only:

a. Resale
b. Use in manufacturing or processing
c. Use in the telecommunication network or in mining or in the generation or distribution of electricity or any other power

10.5 GST has a number of returns that must be filed electronically via the GST Network portal. Here is a list of returns applicable under GST:

GSTR 1: Information regarding outward supplies of commodities or services by registered taxable suppliers. The return due date will be the 10th day of the following month.

GSTR 1A: Information relating to auto-drafted supplies of commodities or services. The return due date will be the 15th day of the following month.

GSTR 2: Information relating to inward supplies of products and services by registered taxable recipients. The return due date will be the 15th day of the following month.

GSTR 2A: Information relating to auto-drafted supplies from GSTR 1 or GSTR 5 to the recipient.

GSTR 3: This is a monthly return based on the finalisation of information relating to outward supplies as well as inward supplies in addition to the payment of tax amount by registered taxable persons. The return due date will be the 20th day of the following month.

GSTR 3A: Notice to return defaulter under Section 46 of the Central GST Act, 2017.

GSTR 4: Quarterly return for registered individuals who have selected the composition levy by composition suppliers. The return due date will be the 18th day of the month next to quarter.

GSTR 4A: Auto-drafted information for registered individuals who have chosen the composition levy.

GSTR 5: Return for NRI taxable individuals by NRI taxable individuals. The return due date will be the 20th day of the following month.

GSTR 5A: Information relating to the supply of database access, online information, or retrieval service by an individual located outside the country made to non-taxable individuals in India.

GSTR 6: Return for Input Service Distributor by Input Service Distributor. The return due date will be the 13th day of the following month.

GSTR 6A: Information relating to auto-drafted supplies from GSTR 1 or GSTR 5 to Input Service Distributors.

GSTR 7: Return for Tax Deducted at Source by the tax deductor. The return due date will be the 10th day of the following month.

GSTR 7A: Tax Deducted at Source Certificate.

GSTR 8: Statement for Tax Collected at Source by the tax collector or e-commerce operator. The return due date will be the 10th day of the following month.

GSTR 9: GST Annual return by registered taxable persons. The return due date will be the 31st of December of the following financial year.

GSTR 9A: Simplified annual return by compounding taxable individuals registered under Section 8.

GSTR 10: GST final return by taxable individual whose registration is either cancelled or surrendered. The return due date will be within three month from the date on which the registration was cancelled or the date on which the cancellation order was issued, whichever is later.

GSTR 11: GST inward supplies statement for (Universal Identification Number) UIN by individuals having UIN and claiming a refund. The return due date will be the 28th day of the month after the month for which the statement was filed.

ITC-1A: GST ITC mismatch report.

10.6 Accounts & Other Records that needs to be Maintained under GST

The provisions with regards to maintenance of Books of accounts and other related documents are contained in Section 35 & 36 of the CGST Act & Chapter VII (Rule 56, 57 & 58) of the CGST Rules, 2017.

a. The following records are mandatorily to be maintained by each & every registered dealer in relation to all businesses and all business locations–specific for that location. The same can be maintained in electronic format.

   (i) production or manufacture of goods;

   (ii) inward and outward supply of goods or services or both;

   (iii) stock of goods;

   (iv) input tax credit availed;

   (v) output tax payable and paid;

   (vi) goods or services imported or exported or

   (vii) supplies attracting payment of tax on reverse charge along with relevant documents, including invoices, bills of supply, delivery challans, credit notes, debit notes, receipt vouchers, payment vouchers, refund vouchers and e-way bills.

   (viii) accounts of stock in respect of each commodity received and supplied by him, and such account shall contain particulars of the opening balance, receipt, supply, goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples and balance of stock including raw materials, finished goods, scrap and wastage thereof.

b. Every registered person shall keep and maintain a separate account of advances received, paid and adjustments made thereto.

c. Every registered person, other than a person paying tax under Section 10, shall keep and maintain an account, containing the details of tax payable (including tax payable in accordance with the provisions of sub-section (3) and sub-section (4) of

Section 9 of the Act), tax collected and paid, input tax, input tax credit claimed, together with a register of tax invoice, credit note, debit note, delivery challan issued or received during any tax period.

d. Every registered person shall keep the particulars of:

(i) Names and complete addresses of suppliers from whom he has received the goods or services;

(ii) Names and complete addresses of the persons to whom he has supplied the goods or services;

(iii) The complete addresses of the premises where the goods are stored by him, including goods stored during transit along with the particulars of the stock stored therein.

e. If any taxable goods are found to be stored at any place(s) other than those declared under sub-rule(6) without the cover of any valid documents, the proper officer shall determine the amount of tax payable on such goods as if such goods have been supplied by the registered person.

f. Every registered person shall keep the books of account at the principal place of business and at every related place(s) of business mentioned in his certificate of registration and such books of account shall include any electronic form of data stored on any electronic device.

g. Any entry in registers, accounts and documents shall not be erased, effaced or overwritten, and all incorrect entries shall be scored out under attestation and thereafter correct entry shall be recorded, and where the registers and other documents are maintained electronically, **a log of every entry edited or deleted shall be maintained.**

h. Every registered person manufacturing goods shall maintain monthly production accounts, showing the quantitative details of raw materials or services used in the manufacture and quantitative details of the goods so manufactured including the waste and by products thereof.

i. Every registered person supplying services shall maintain the accounts showing the quantitative details of goods used in the provision of each service, details of input services Utilised and the services supplied.

j. Every registered person executing works contract shall keep separate accounts for each works contract showing

(i) The names and addresses of the persons on whose behalf the works contract is executed;

(ii) Description, value and quantity (wherever applicable) of goods or services received for the execution of works contract;

(iii) Description, value and quantity (wherever applicable) of goods or services Utilised in the execution of each works contract;

(iv) The details of payment received in respect of each works contract; and

(v) The names and addresses of suppliers from whom he has received goods or services.

k. Every owner or operator of warehouse or godown or any other place used for storage of goods and every transporter, irrespective of whether he is a registered person or not, shall maintain records of the consigner, consignee and other relevant details of the goods in such manner as may be prescribed.

l. Any person engaged in the business of **transporting goods** shall maintain records of goods transported, delivered

and goods stored in transit by him along with GSTIN of the registered consignor and consignee for each of his branches.

m. Every **owner or operator of a warehouse** or godown shall maintain books of accounts with respect to the period for which particular goods remain in the warehouse, including the particulars relating to dispatch, movement, receipt, and disposal of such goods.

n. The records under these rules may be maintained in electronic form and the record so maintained shall be authenticated by means of a digital signature.

o. Accounts maintained by the registered person together with all invoices, bills of supply, credit and debit notes, and delivery challans relating to stocks, deliveries, inward supply and outward supply shall be preserved for the period as provided in Section 36 of the Act and shall be kept at every related place of business mentioned in the certificate of registration i.e 6 years from end of financial year.

10.7 Books/ Records Required to be Maintained: The engineering industries coming under the purview of Section 44 AA of the IT Act, are required to maintain the records prescribed under that provision, in addition to the records under the GST as mentioned above. The records maintained under GST laws will be immensely helpful for income-tax purpose. Where these concerns are corporate bodies, records prescribed under the Companies Act are also required to be maintained. The industries to which Cost Accounting/ Audit rules are applicable *u/s* 209 of the Companies Act, are obliged to maintain cost audit records. Details regarding statutory audits under the Companies Act, Cost Audit, and special audit have already been discussed in Volume-I.

11. EXAMINATION OF MANUFACTURING-CUM-TRADING ACCOUNTS

11.1 Purchases: One of the most important aspect in investigation is to look into the purchases. Inflation of purchases is a common mode of tax evasion. There are instances where purchases are either found to be bogus in nature or are inflated. Income-tax Act allows for adjustments to be made in respect of purchases made from related parties as defined *u/s* 40A(2) (b) of the Act. However, in case of non related parties one needs to be circumspect. The rates of various items used in engineering industries are verifiable from different journals mentioning the prices. Different type of assessee use different documents and registers for purchases, for example:

a. Purchase invoice, purchase bills, proforma invoice.

b. Delivery challans.

c. Bill of transportation

d. Slip of measurement/ weighment

e. Octroi bill or cess charging bill of municipal corporation

f. Unloading expense voucher

g. Gate pass slip

h. Inward register

i. Purchase register

j. Stock register

k. Store register

Common and general methods of inflation of purchases have been discussed in the Chapters relating to Trading Account, and Manufacturing Account, in Volume-I.

11.2 Production Account: Examination of Manufacturing/ Production account is of paramount importance in these cases. For this, co-relation of quantity records of consumption of raw materials and production of finished goods,

and the knowledge of the input: output ratios of the particular industry, is essential. It is useful to first examine following details before taking up serious investigation work:

a. Licensed/ Registered/ Installed capacity of the unit
b. Type and quality of finished goods and main by-products
c. Production capacity Utilised by the assessee
d. Capacity enhanced by installation of new machineries
e. Level of technology being employed
f. Purchase of new machinery
g. Age of Plant and Machinery and technology
h. Actual production shown by the assessee
i. Reasons for variation of production *vis-á-vis* the installed capacity
j. Shortage and wastage shown by the assessee
k. Standard or norms fixed by Trade Association, Government authorities or available in project reports of the assessee or financial institutions
l. Time taken in one complete production cycle.

It may be useful to cross verify the quantity particulars appearing in the inward register and Stock register with the corresponding entries in first part of production register, and thereafter with the production of the finished goods in same register. Input-output ratios can be worked out for selected periods, i.e., months, fortnights, weeks, etc.., on random basis and compared with industry norms. Any abnormal variations may require detailed examination. There may be some difficulty in working out input-output ratios where the units of measurement of the input are different from those of the output. In these cases, standard conversion factors have to be applied.

11.3 Wastage in Production Account: There are visible as well as invisible wastage in engineering industry, which have a direct impact on gross profit. In order to find out the wastage, quantitative details have to be obtained and examined with reference to the quantity of raw materials consumed and quantity of finished goods and by-product produced. The normal per centages of loss due to shortage/ wastage, varies from industry to industry and also depends upon the type of raw materials and technology used. Industry norms of wastage are usually available from trade bodies, Government authorities, etc. Many times, assessees try to present their accounts in such a way that over-all wastage in terms of percentage will conform to industry norms. However, if month wise or fortnightly accounts are prepared, an entirely different picture may emerge. Therefore, the AO should test-check the production register and work out percentage of wastage on particular dates. If such per centages tally with overall final result disclosed by assessee and wastage are not apparently on higher side, the book result cannot be easily doubted but where test-check shows abnormal variations in wastage percentage of different periods, this may require detailed examination.

11.4 Wastage Pattern in Various Industries: In engineering industry wastage pattern is not uniform but varies from unit to unit, industry to industry, product to product and plant to plant. In an older unit, having older technology, wastage may be high. If at the out-set it appears that wastage is on higher side, the AO can investigate the accounts with reference to normal standards or some comparable cases. If cases are not available for comparison and standard is not found applicable, one can always go by test-check of input and output ratio on a few random dates of production which may bring out wastage ratios different from those disclosed by the assessee in the final statements of account. If records of wastage are not kept on a day-to-day or weekly or fortnightly basis,

then the production records may not be reliable. Different types of wastage/ losses incurred in the production process in some engineering industries are discussed below:

a. Steel Re-rolling Mills: In steel rolling mills and re-rolling mills two types of wastage are shown i.e. burning loss, and, melting loss. Burning loss is invisible loss whereas melting loss is visible loss. The burning process can be through coal-fired or oil-fired furnaces. Studies reveal that, in case of oil-fired furnaces, the normal burning loss is between 2% to 2.5%. In case of coal-fired furnace, burning loss can be from 4% to 5%. If an assessee claims an excessive burning loss then examination of the entire manufacturing process, input: output ratio, quality of raw materials, rate of raw materials, as also study of other comparable cases has to be made.

b. Auto-parts Manufacturers: Due to a large number of units manufacturing different type of pistons, rings and auto parts, it is difficult to have standard pattern of this industry. In most of the cases raw material is purchased by weight whereas goods are produced and sold in numbers. Therefore it is difficult to have a quantity-wise correlation between purchases and sales. As regards wastage one has to go into details of day-to-day production. The products of auto parts manufacturers, are normally of standard specifications, and variation is only in respect of sizes. Therefore, input and output ratios can not be abnormal. In these industries, burning loss or process loss may also be there.

c. Electric Motors: While investigating the case of electric motor manufacturers it has to be kept in mind that electric motors vary from motors of small fractional horse power to special purpose giant motors. The cost of production of electric motors comprises of:

(i) Stampings for stator and for rotor. (Stampings are made out of dynamo grade electrical steel lamination sheets. The purpose of the stamping is to carry the electromagnetic flux).

(ii) Enamel covered copper wires are used in the windings of stators and rotors. The wires carry the input current to induce the electromagnetic flux.

(iii) Copper bars and end rings or aluminum for rotors (other than wound rotors).

(iv) Steel round bars for making shaft.

(v) Castings for enclosure of the motor and for other parts.

(vi) Ball bearings used for smooth running of the rotor. Bush bearings are often used in small motors.

(vii) Insulation materials such as papers, varnish, etc..

(viii) Hardware, paints and small components.

A study reveals that total wastage in the manufacturing of motors ranges from 4.3 to 5.2%.

11.5 Manufacturing Account:

a. The general issues relating to examination of manufacturing account have been discussed in the chapter relating to "Manufacturing Account", in Volume-I.

b. In the engineering industry manufacturing expenses include expenses on raw materials, consumables, power and fuel, wages and salary of factory, repairs and maintenance, deprecation and other overhead expenses. While going through the manufacturing account, the AO must verify the input:output ratios of main raw materials, power and fuel vis-à-vis the production of individual products. The AO has also to compare actual physical consumption per unit of production with reference to standards

available in literature, & studies of trade associations etc. At times assessees claim correct expenditure on power and fuel but understate the productions. Therefore, suppression of production can be detected by applying standard input-output ratios.

c. The AO must distinguish between direct labour cost on production and indirect employee cost on production. He should also verify total man days of direct labour employed during the year and average number of workers employed for the year. Thereafter, he has to examine direct labour cost per unit of production. This will give a clue as to whether wages and salaries have been inflated.

d. Manufacturing expenses also include:

   (i) Stores and Spares expenses

   (ii) Maintenance and Repair

   (iii) Outside Contract Repair Charges

   (iv) Purchase of Miscellaneous items

It is easy to inflate expenditure under above heads by creating self made vouchers. A scrutiny of such vouchers may show that the signatures appearing on revenue stamps for payment are of the same persons.

11.6 Closing Stock:

More often than not, the auditors mention that the closing stock is valued on the basis of feedback provided by management. As a rule the closing stock is valued either at the historical cost or market value as per practice adopted by the assessee. It may be worthwhile to verify certain items of closing stock as regards its historical cost or market value by looking into instances of sale of such items in the closing months of the year. Important features to be borne in mind are:

a. Value of closing stock, in most cases, is shown in an ambiguous fashion. It is very common to exclude or undervalue the work-in-progress.

b. Many assessees value their raw material on the basis of purchase bills of 15th to 30th March. Often direct expenses like transportation, duties, cess, fees, Octroi, unloading charges, are not included in the value of closing Stock of raw materials. This is contrary to Supreme Court judgment in CIT *vs*. British Paints (India) Ltd. (1991) 188 ITR 44 (SC).

c. In one case, the assessee had valued finished goods on the basis of last sale bill dt. 24th March, as no sale was affected thereafter. While investigating the case, the AO found considerable difference between the sale price of 24th March and the sale bill of 1st April.

d. Often goods-in-transit, and/ or goods sent for approval, are not included in the inventory of closing stock.

e. It is always useful to compare the Stock statement furnished by the assessee to financial institutions and banks. If Stock statement given to the bank differs from Stock declared in books, the difference in stock can be added to the closing Stock as suppression of closing stock. This issue has now been settled by the Supreme Court of India in the case of Ghasiram Agrawal *vs.* CIT 201 ITR Page 192 while dismissing the SLP of the assessee against the judgment of Hon'ble Gauhati High Court.

f. Consignment Sales present another area of suppression of closing Stock. Some assessees do not include the goods sent to consignee in their closing Stock.

g. Some other malpractices for undervaluation of closing Stock are as under:

h. Undervaluation of Stock by fixing up predetermined GP rate, and showing the balancing figure as closing Stock.

i. Undervaluation of Stock by mis-referring the purchase bills

(i) Undervaluation of Stock on the basis of purchase bills but without including direct expenses

(ii) Undervaluation of Stock by referring to some sale bills of month of March, but not of 31st March

(iii) Undervaluation of Stock on the basis of market price by referring to under-invoiced sale bills of last week of March

(iv) Undervaluation of Stock by taking average purchase cost

(v) Undervaluation of Stock on the basis of non-genuine purchases of March

(vi) Undervaluation of Stock of work-in-progress or unfinished goods

(vii) Undervaluation of Stock of semifinished goods

11.7 Under Invoicing of Sales: Suppression of sales is often resorted in various manners. There may be cases of outright understatement of sale price in bills and collecting a part in cash outside the books. Under invoicing can also be done through intermediary arrangements. Goods are sold directly to the ultimate purchaser but documents are prepared to show sales through a chain of intermediaries. The sale made to the real purchaser at the end of the chain is invoiced at real market rate. All these intermediaries are legally constituted and most of them file their returns of income. But in this arrangement premium or profit is split-up at various stages to reduce the incidence of tax. In some cases of under-invoicing, some assessees issue Debit Memo or Debit Note in later period after close of the accounting year to misappropriate the respective amounts. While verifying sale bills, the AO has to examine the system adopted for preparing the invoices and recording the figure of sales in accounts. It must be verified whether manufacturer has a system for writing sales figure in terms of both quantity and value for each type of product by grouping of invoices. If that is there then invoices must be reconciled with figure of sales. Than, the AO can prepare a price-profile of that product and thereafter tally it with the sale proceeds made to the various parties.

12. TAX AUDIT AND COST AUDIT REPORTS

The revised Form 3CD for Tax Audit Reports contains important data including financial ratios and quantity data of production/ consumption etc. These audit reports can be an important tool in the hands of AO investigating the case of a manufacturing concern. The issues arising from these audit reports have been discussed in the Chapters relating to "Tax Audit Reports" and "Making Quality Assessments" in Volume-I. Similarly, where cost audit rules apply to a concern, Cost Audit Reports can be examined by the AO. This subject has been discussed in the Chapter titled "Cost Audit", in Volume-I. Recourse can also be taken to special audit *u/s* 142(2A) in appropriate cases.

13. USE OF TALLY SOFTWARE FOR DETECTING TAX EVASION

13.1 Income-tax is always levied on surplus income. Surplus income is the one where receipts are higher than expenses. More is this difference, more is the tax liability. Hence, any tax evader would always like to bridge the difference between the receipts and the expenses. Hence, the tax evader would either suppress his actual receipts or inflate its actual expenses. Inflation of expenses is carried out by mostly by following ways:

a. Bogus Purchases

b. Bogus Sub-contract expenses

c. Bogus commission expenses.

d. Over-invoicing of expenses.

Common tendency of the assessee is to bring back the money generated through tax evasion into the normal books. This is reflected in the books in the following forms:

a. Share Application Money

b. Securities Premium

c. Unsecured Loan

13.2 It is advisable to concentrate on the software used for accounting purpose. The most common software used for Accounting purpose is "TALLY". Now-a-days in big organisations, ERP is used for accounting purpose. Although ERP cannot be brought for verification during assessment stage, Tally can always be brought on for verification of accounts in the office itself. The advantages of operating Tally at office are:

a. Rather than relying on the data submitted by the assessee at the Macro level, one can go to the micro level and analyze the accounts.

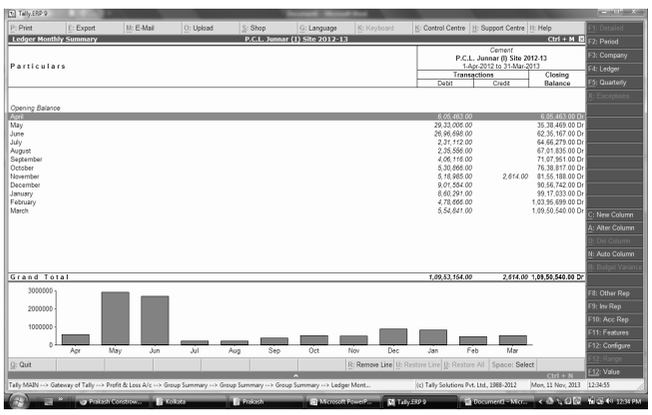
b. One can study the patterns of expenses over the years and also over the months in a year.

c. The patterns of various expenses can also be analyzed over all the products/ projects of the assessee.

d. The abnormality can be visually seen and then further probed into.

13.3 Examples of Bogus Purchases found through Tally

EXAMPLE A



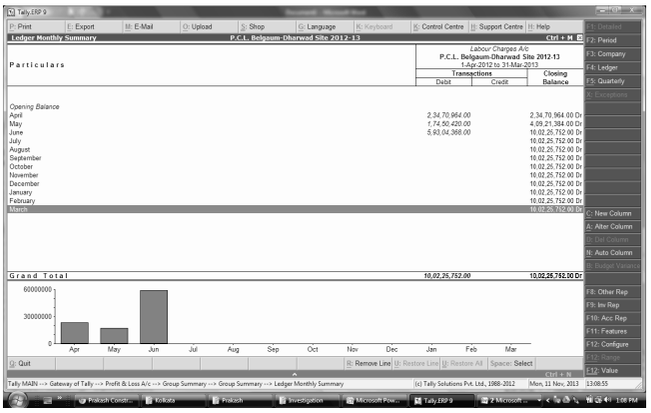
a. The above ledger shows the consumption of cement over one year.

b. A mere look at it shows more than average consumption in two months-May and June.

c. Further enquiries revealed that the purchases were made from one of the associate concerns of the assessee for which no supporting documents were available with the assessee.

d. Bogus purchases admitted.

EXAMPLE B



a. The above ledger shows the labour charges incurred for 3 months.

b. Since the project was completed in June, no more expenses debited after June.

c. However, June month showed abnormal expenses.

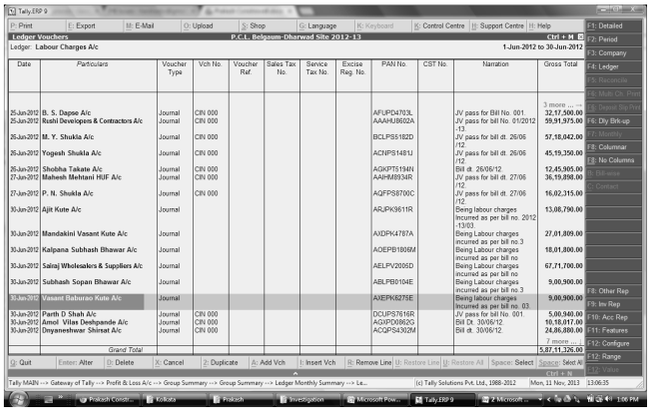
d. Next step was to go into details of June expenses. Next screen shot shows June expenses details.

Ledger Vouchers
P.C.L. Belgaum-Dharwad Site 2012-13
Ledger: Labour Charges A/c
1-Jun-2012 to 30-Jun-2012
Date
Particulars
Vch Type
Vch No.
Debit
Credit
01-6-2012 To Opening A/c Journal CIN 000 2,34,70,964.00
26-6-2012 Rushi Developers & Contractors A/c Journal CIN 000 60,52,800.00
26-6-2012 M. Y. Shukla A/c Journal CIN 000 57,75,800.00
26-6-2012 Yogesh Shukla A/c Journal CIN 000 45,65,000.00
26-6-2012 Shobha Takate A/c Journal CIN 000 12,58,490.00
27-6-2012 Mahesh Mehtani HUF A/c Journal CIN 000 26,56,462.00
27-6-2012 P. N. Shukla A/c Journal CIN 000 16,18,500.00
30-6-2012 Ajit Kute A/c Journal 13,22,010.00
30-6-2012 Mandakini Vasant Kute A/c Journal 27,29,100.00
30-6-2012 Kalpana Subhash Bhawar A/c Journal 18,20,000.00
30-6-2012 Sairaj Wholesalers & Suppliers A/c Journal 68,40,100.00
30-6-2012 Subhash Sopan Bhawar A/c Journal 9,10,000.00
30-6-2012 Vasant Baburao Kute A/c Journal 9,10,000.00
30-6-2012 Parth D Shah A/c Journal CIN 000 5,06,000.00
30-6-2012 Amol Vitas Deshpande A/c Journal CIN 000 10,28,300.00
30-6-2012 Dnyaneshwar Shirsat A/c Journal CIN 000 25,12,000.00
30-6-2012 Balkrishna. T. Takate HUF A/c Journal CIN 000 12,41,510.00
30-6-2012 Atal & Company A/c Journal 68,90,806.00
30-6-2012 Amit Hanuman Boob A/c Journal 20,29,400.00
30-6-2012 Nilesh Gangadhar Junnare A/c Journal 14,14,600.00
30-6-2012 Anil Jaywant Gangurde A/c Journal 12,75,000.00
30-6-2012 Suresh Lalchand Dhanwani A/c Journal 8,98,990.00
30-6-2012 Ajay Shinde Journal 8,00,000.00
Opening Balance : 4,09,21,384.00
Current Total : 5,93,04,368.00
Closing Balance : 10,02,25,752.00
Quit
Enter: Alter
Delete
Cancel
Duplicate
Add Vch
Insert Vch
Remove Line
Restore Line
Restore All
Space: Select
Space: Select All

e. By looking into these details, one cannot make up as to what would be bogus expenses, if any.

f. Solution is to look into these details in Columnar format, where all entry details are provided.

g. Next screen shot is that of columnar entry details of these June expenses.



h. If one looks carefully at these entries, one could make out that against some of the entries, no voucher numbers were mentioned.

i. These entries can be picked up for further verification.

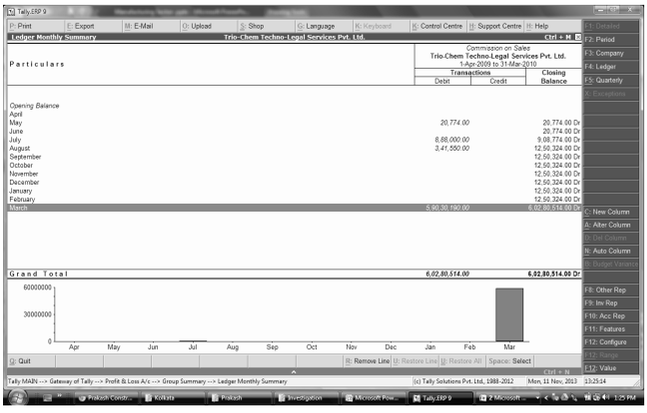
j. Next step is the verification of the bank accounts of these concerns.

k. There would invariably be cash withdrawals immediately after the cheque deposits into these accounts.

l. Proves the bogus sub-contract expenses.

EXAMPLE C

Key is to again take the ledger of respective head of expenses from tally. Then verify it across the different years and in a year, across the various months. Make general enquiries through Google about the existence and credentials of concerns to whom commission was paid. The assessee won't admit easily the bogus commission entries since it is a service and one cannot value it.



a. The above screen shot shows the commission ledger in the books of the assessee for one year.

b. It can be noticed that in the month of March, the assessee has debited extra-ordinary commission expenses of Rs. 5.90 crore.

c. Further verification showed that out of these 5.90 crore, Rs. 5.89 crore were paid to one party, *viz.* M/s QST Ltd.

d. The assessee was cornered and lots of questions were asked regarding the services provided by the said concern.

e. Finally admitted the bogus commission entry.

14. USE OF ERP FOR DETECTION OF TAX EVASION

14.1 Basic Concept of ERP

ERP stands for "*enterprise resource planning*". It is a business management software which uses system of integrated applications to manage the business. It contains many modules. Each ERP module is mostly focused on one area of business processes, such as Purchase or marketing. Common ERP modules include those for product planning, material purchasing, inventory control, distribution, accounting, marketing, finance and HR. All modules are interconnected and they are shared by all the departments in the organisation in order to smooth the flow of data across the organisation.

14.2 ERP Operations

There are different departments within the company. The departments which would be relevant for income-tax investigation purpose are as follows:

a. Production Planning Department/ Design Department

b. Purchase Department

c. Stores Department

d. Accounts Department

14.3 Basic Flow of Operations

a. The Design Department prepares drawing for all the individual processes/ components and accordingly, raises Bill of Material **(BOM)** for each individual component so designed for the project.

b. Based on the BOM, the Material Requisition ("**MR**") or Purchase Requisition ("**PR**") is communicated by the Production Planning Department.

c. Once this MR/ PR is received by the Purchase department, a Purchase Order("**PO**") is generated by Purchase Department.

d. The supplier then sends the material alongwith the Delivery Challan, where it is received by the Stores Department.

e. The Stores Department then prepares Goods Receipt Note (**GRN**)/ Goods Receipts-cum-Inspection Note (**GRIN**)/ Goods Inward Note (**GIN**).

f. GIN/ GRIN is then handed over to Quality Control Department for inspection in case of raw material or component

g. The GIN alongwith the Tax Invoice, Challans and supporting documents are sent to Accounts Department for payment.

h. After entering the GIN, all the details of that particular GIN gets populated on the Accounts Module screen.

i. Based on this data, Payment Vouchers ("**PV**") are prepared by the Accounts Department.

j. PV is then printed and forwarded to internal auditor. After this, the PV is again sent to Accounts Department for preparation of banking voucher and cheque which get printed through system.

14.4 Example A

a. Alongwith the Normal ERP Modules, a separate module was installed.

b. This Separate Software Module named as "SPO System" was programmed to generate a separate series of GIN bearing code 99.

c. A separate log-in id was created to access this module and which was known only to the single person who used to make entries into this module.

d. The salient features of this separate software module-SPO System-was that it contained 3 different functions-Purchase Order Generation, GIN generation and Bill Passing Purchase Voucher Generation-in a single module.

e. In a normal course, one Department or user of one module cannot access the other module. However this module contained all the three different and crucial functionalities in order to facilitate manipulations.

f. The SPO System was linked neither to the Purchase Department nor to the Stores Department. However, it was linked to the Accounts Department, so that the Payment Voucher numbers printessd on the PVs could be in continuation of all other PVs.

g. The Purchase Department was asked to show the Purchase Orders of some suspicious dealers.

h. It was told that the Purchase Orders of those dealers were not available with them.

i. It was checked and then realised that all such Purchase Orders and GINs bear the code 99.

j. These GINs were gathered separately and then confronted to the Software development department head who confessed that they were prepared using separate module.

k. Traced for last 8 years. Total bogus purchases were 157 Crores.

14.5 Example B

a. A Purchase Officer was entrusted upon to generate the Purchase Orders within ERP System, for which no material was to be received.

b. All such Purchase orders were generated using the log-in id "FA1".

c. These purchases were recorded for the material to be used in site offices and never for the factory office of the assessee.

d. When the ERP System was analyzed, it was found that there were certain Purchase Orders for which no PR was raised.

e. Normally all POs are backed by PRs; only in exceptional cases, POs are not backed by PRs.

f. All such POs were segregated. It was then realized that a particular log-in id and a particular dealer appears with unusual frequency for such POs.

g. This fact was confronted to the user who has entered these POs who then spilled the beans. The total bogus purchases for block period were 150 Crores.

14.6 Example C

a. "C" was using ERP system known as CLARITY.

b. Separate codes were allotted by Systems Division of C for each officer working on separate operation In purchase department such codes were known as buyer codes and were to be operated with passwords.

c. One separate code, 'code 70' was allotted for corporate functions and known as 'corporate code'.

d. Code 70 was not known to other persons in any other department.

e. All the procedure related to purchases of material through this code was handled by only one person in accounts division who is close to M.D.

f. While generating GRIR, the documents needed for this were not available and procedure beyond this was blocked for this code. This delinked its connection with stores and manufacturing but had connection only with accounts.

g. After understanding the procedure of purchase and issue of materials, list of all the buyer codes was obtained through Systems Division.

h. Corporate code 70 was shortlisted as suspicious which got strengthened by the fact that nobody knew about functions of that code, which was buyer code and should have been normally operated by purchase department personnel.

i. A query was run on CLARITY to generate a report of parties from whom purchases from this code were done.

j. A query generated a report of 28 parties from F.Y. 2007–08 onwards totaling to 12.70 Crs.

k. Simultaneously, we verified the suspicious parties in the BRIEF in purchase module of CLARITY. Purchases of these parties were also done through corporate code 70.

l. GRIR report was generated, which showed no documents of delivery challan, weight slip, transport slip were available on the fields in GRIR page.

m. A query generated a report of 28 parties from F.Y. 2007–08 onwards totalling to 12.70 Crs.

n. Simultaneously, we verified the suspicious parties in the BRIEF in purchase module of CLARITY. Purchases of these parties were also done through corporate code 70.

o. GRIR report was generated, which showed no documents of delivery challan, weight slip, transport slip were available on the fields in GRIR page.

p. On searching his computer thoroughly, all the Excel sheets of generation and application of cash for last three years were found which was admitted by Directors.

q. Purchases from similar parties were verified for earlier years on the stored data base in server. On confrontation, assessee admitted of bogus purchases in earlier years also.

14.7 Gist of Above Cases

If one already has certain data about the bogus dealers, identify their Purchase Orders and GRNs separately. Then it will be important to locate common grounds in these Purchase Orders. After locating the common thread, it will be required to be applied for all the years and for all the purchases. If no ready-made data is available then it will be important to just check the normal procedure and find the missing link in the operations for certain purchases. Most importantly, one must always look out for the difference in the Stores Data and Accounts Data. As a standard practice, the bogus purchases are never entered in the Stores Module of the ERP, but are always entered in the Accounts module. Then run the query on the System to find out the difference between Stores Data and Accounts Data. This will give desired result.

CHAPTER

2

Cotton Textile Industry

1. INTRODUCTION

The cotton textile industry is one of the oldest industries in India. In the 18th Century, the famous 'muslin' manufactured at Dacca were exported to Europe. Thus, this industry has a very important place in the national economy. It not only contributes substantially to the state and national exchequers but also brings in a large amount of foreign exchange by way of export. The industry gives employment to large number of people, particularly in Maharashtra, Gujarat and Tamilnadu, where the bulk of the textile mills of the country are located. The manufacture of textiles involves different stages of processing through the various units of a textile mill.

2. GINNING

2.1 The cotton gin is where cotton fiber is separated from the cotton seed. Ginning is the process of separating the cotton seeds from raw cotton or 'kapas', in order to get the lint (cotton in a fluffy state). The process is done in ginning factories which purchase 'kapas' and convert it into lint and seeds. In this process, the cotton is vacuumed into tubes that carry it to a dryer to reduce moisture and improve the fiber quality. Then it runs through cleaning equipment to remove leaf trash, sticks and other foreign matter.

2.2 The cotton boll is a protective fruit and when the plant is grown commercially, it is stripped from the seed by ginning and the lint is then processed into cotton fibre. For unit weight of fibre, about 1.6 units of seeds are produced. The seeds are about 15% of the value of the crop and are pressed to make oil and used as ruminant animal feed. The cottonseed price in April 2018 was in range of Rs. 1200 to Rs. 1300 per quintal. Cottonseed and Cottonseed hulls are good source of protein and serve as an excellent source of feed for the livestock. The cottonseed meal after being dried can be used as a dry organic fertilizer. The seed oil extracted from the kernels, after being refined, serves as a good edible and nutritious food. It is also used in the production of shortening and margarine. The fine quality oil extracted from cottonseed during the extraction process is also used in cosmetics, such as moisturizing lotions and bath soaps. The yield of cotton seed vis-a-vis the raw cotton after the ginning process may be analyzed to find the inconsistency in purchases.

2.3 There are two kinds of ginning-**roller ginning** and **saw ginning**. Roller ginning is also of two kinds-**single** and **double**. The latter produces a superior quality of 'lint'.

3. ROLLER GINNING

Roller ginning of 'kapas' is carried out manually. The kapas is also taken to the 'opener' or 'jhamba' manually. This removes the impurities. It is then taken to the roller machines. Labourers put the 'kapas' into the rolling machine by hand. These machines separate cotton from cotton seeds. The ginned cotton is carried in loose bales to the godown, where it is stored for processing.

4. SAW GINNING

4.1 Saw ginning came into use only about 25 years back and is popular particularly with the textile mills of Mumbai. In this process the services of the 'opener' i.e. 'jhamba', which removes impurities, are dispensed with, as it has an automatic 'opener'. The raw 'kapas' is sucked through the pipe into the saw machine. It is then fed into the 'opener' which removes dust, and other impurities mixed in the 'kapas'. This 'opener' or 'jhamba' automatically opens the 'kapas'. The 'kapas' is then fed into the machine which separates cotton from cotton seeds. Cotton seeds are automatically separated to one side, while the lint is sucked into the perforated pipes where it is cleared of impurities. The cleared cotton is then put into bags. These bags are stocked in godown and later transferred to the pressing section.

4.2 The saw ginning process gives more refined cotton, as it entails cleaning at two places. This, however, gives a lesser yield because, apart from impurities, some lint is also left on 'binolas'. The yield and shortage depends on quality of cotton and type of machine. However, labour expenses are lower in this process because of automation. Saw ginning is now losing ground because of the excessive loss involved in the process.

5. COTTON PRESSING

5.1 In some ginning factories, there is also a Pressing section. After ginning, the lint obtained is in a fluffy state. It is pressed and packed in this section. If the ginning factory has no Pressing section, the lint is taken to a pressing factory, where it is pressed and packed into bales, against fixed pressing charges per bale.

5.2 The device usually adopted by the Pressing factory to reduce its profit is to inflate the quantity of iron hoops and hessian purchased and Utilised for baling. Quantitative details of these two articles should be obtained and the reasonableness of the consumption checked with reference to the bales packed. Usually, a fixed quantity of iron hoops and hessian is required for each bale pressed and packed. The expenses on stores and wages should also be examined thoroughly, and ratio analysis may be done to find inconsistency in the books.

6. TYPES OF PRESSES

Generally, there are three types of presses in use. These are:

a. **Double press**

b. **Single press**, and

c. **Common press**

The Presses are run either by steam from a coal-fired furnace or by electricity. The difference in these three types of Presses is that the double Press has the maximum capacity, while the single Press has less capacity and the common Press has the minimum capacity.

7. PURCHASES OF RAW COTTON

The purchases may be either directly from cotton growers or from dealers/ brokers in raw cotton. The purchase rate of 'kapas' depends upon its quality. The purchases of raw cotton from dealers and through brokers are generally verifiable, whereas purchases made from growers are usually not capable of proper

verification. However, daily market reports are available in major cotton centres and it may be useful to compare the purchase rates of a few selected items as shown by the assessee with the market rates given in those reports.

8. CASH PURCHASES

8.1 Since most of the purchases are from cultivators, there may not be satisfactory evidence to prove all the purchases. It is usual to inflate 'kapas' purchases, both in terms of quantity and value. Where the cotton traders or the spinning and weaving mills themselves own a ginning factory, the chances of making such inflation are more. For instance, in one case, the partners of a firm running a textile mill owned certain lands on which cotton was grown. In their personal accounts, they showed large credits for sales of raw cotton or 'kapas' to a ginning factory in support of such purchases. The books of the ginning factory correspondingly showed large quantities of 'kapas' purchases from these partners at the highest market rate. However, on close scrutiny, it was found that the quantity shown was much higher than could have been obtained from the area of land owned by them, even at the highest yield for cotton recorded by the District Agricultural Officer. An inference could, therefore be drawn that either fictitious sales had been entered, in order to bring into books undisclosed income of these partners, or they had purchased 'kapas' from agriculturists outside the books, and had recorded only the sales, thus bringing their undisclosed income into books of account surreptitiously.

8.2 Similarly, when the disclosed output of lint is poor and/ or the wastage excessive, a possible reason can be that the 'kapas' purchased was of an inferior quality, in which case the average purchase rate ought to be less than in other similar cases.

8.3 Where there are both cash and credit purchases, the rates paid for cash purchases from agriculturists should ordinarily be less than the rate paid for 'kapas' purchased from the market or in auction. If the rate for cash purchases is higher, it may indicate inflation of purchases.

9. PURCHASES THROUGH SUSPENSE ACCOUNTS

9.1 Such purchases are usually supported by 'bought notes' issued by the owners of ginning factories. At times, when money is drawn for making purchases from growers, a 'suspense account' is opened. It is necessary that purchases financed through 'suspense account', are scrutinised properly for detecting any inflation of purchases. In some cases the value of purchases exceeds the money taken to the 'suspense account' for financing such purchases. If this is noticed, it will be necessary to inquire as to how such purchases have been financed. In the absence of a proper explanation, the presumption would be that the purchases have been inflated or have been made out of undisclosed sources.

9.2 A rough and ready method of determining the extent of inflation of such purchases is to deduct from the value of the goods purchased the money passed through the 'suspense account' less the travelling, lodging and boarding expenses of the employees. The dates of purchases made from the purchase centres by the employees and the dates on which funds were withdrawn from the 'suspense account' should also be carefully looked into. The mode of taking money by employees to the purchase centres should then be verified for detecting any manipulation of purchases. Location of purchases made from the place of vendor and that of the assessee is also vital to be looked into so as to inquire about the movement of cash from one place to another.

9.3 Sometimes, claims are made that the funds withdrawn by the employees through the 'suspense account' have not been Utilised fully and these are deposited back in the books of accounts. Such claims should be thoroughly checked with reference to the purchase and

stock registers. The time lag between the dates of withdrawals and the dates of bringing the money back into the books would help to establish whether the funds advanced have been Utilised for purchases or for some other purposes. The day book should also be scrutinized for finding out any cash deficit, as the funds withdrawn for purchases are usually adjusted in the books at assessee's convenience.

9.4 At times, funds are withdrawn from the books for financing purchases from growers, and bank drafts are purchased. Such bank drafts are encashed at the purchasing centres for payments to growers. It would be necessary to verify the withdrawal of the money for purchasing the drafts and the dates of encashment of the bank drafts at the purchasing centres. Such dates can be correlated with the dates of purchases made at the purchasing centres, the 'bought notes', and the day book. The stock register can also be checked up with reference to the dates of such purchases.

10. SCRUTINY OF PURCHASES

The rates of the purchases made directly from the growers should be compared with the purchases made through brokers/ dealers in raw cotton. It is necessary that the purchases made directly from the growers should be carefully enquired into for detecting any inflation. Apart from inquiring into the sources of funds and the dates of purchases, the stock register and the day book should also be scrutinised. A complete tally of the movement of stock purchased, processed/ consumed and sold to the consumers be checked. Yield ratio of the industry at the prevailing point of time also needs to be considered to catch any anamolies or inconsistencies in the books. This may also invite any instances/ reasons for rejecting the books and determining the industry profit rates to be the income of the assessee. Nonetheless, a fair and practical approach may be adopted in exercising and adopting such rate of profit once books are rejected and overall facts and circumstances like industrial profit margin, location of vendors and the assessee, trend analysis of turnover, background of assessee in past, etc needs to be duly considered.

11. OUTPUT FROM GINNING FACTORIES

11.1 While examining the accounts of a ginning factory, it is always necessary to judge the reasonableness of the output of lint and seeds with reference to the quantity of 'kapas' ginned. The yield in processing of raw cotton into lint depends upon the quality of the raw cotton and the type of machines used. The normal yield and the shortages are as under:

Process	Type	Yield	Shortage
Saw ginning	Long staple quality	32% to 34%	1.5% to 2.5%
Roller ginning	Desi kapas	36%	1.5%

11.2 Studies conducted by Ahmedabad Textile Industry's Research Association, (ATIRA) for improving ginning technology reveal the following:

When Indian cottons are compared with foreign cottons, Indian cottons are comparable or even superior than foreign cottons in fibre length, fineness and strength. In foreign countries mechanical harvesting is adopted and trash content is 20 to 25%. This is 7 to 8% in most of the Indian kapas material. The trash content after ginning process, is not more than 2 to 3% in foreign cotton bales while in Indian bales, it is 4 to 6%. Average trash content in Indian cotton bales is 6 to 7% and the maximum level is 15% inspite of the manual harvesting system.

11.3 If cleaning machines at ginning, post-ginning cleaner (to remove seed-coat fragments), and pneumatic cotton conveying system are adopted, contaminants in cotton can be reduced thereby improving the cotton quality. Enquiries can be made to find out whether such 'modernisation' has been carried out. Accordingly, cotton realisation percentage

may be verified from the books of accounts. In case the yield and shortages are abnormal, the accounts should be scrutinised for detecting possible manipulation of purchases.

SPINNING MILLS

12. SPINNING PROCESS

12.1 Spinning is the mechanical process of converting cotton into yarn suitable for manufacture of cloth or other cotton fabrics.

12.2 An important parameter in spinning process is **'count'** by which the quality of yarn is determined. The count of the yarn depends on its weight. Yarn of 840 yards is called a **'hank'**. If one hank of yarn weighs one pound, then count of that yarn is 1. If 40 hanks of yarn weigh one pound, then the count of that yarn is 40. The higher the count, the finer will be the yarn.

12.3 Raw Material: With development of technology, now in addition to cotton, jute and also other man-made fibres such as viscose and polyester are used as raw material either singly or in combination so as to manufacture mixed fabrics such as terry cot. The factors which make fibres suitable for textiles are length, strength, pliability, diameter, abrasion, resistance and power of cohesion etc. Besides, fibres must be pleasant to touch, absorbent to the extent that they can be dyed, comfortable to wear and washable by some method. Not all the desirable properties are available in any one fibre. Cotton is a natural fibre which is still considered as one of the most suitable textile fibres.

12.4 As the raw material constitutes about 55 per cent of the total cost of yarn, and about 50 per cent of the total cost of cloth, raw material procurement plays a significant part in textile industry. Apart from being proficient in finalising deals at the right time to take advantage of the market, one must be adept in selecting the right cotton to suit the end use and must have intimate knowledge of the amenability of various types of cottons/ fibre to spinning. Nowadays, the knowledge and practice of hand sampling of classier cotton is supplemented with the physical properties measured by sophisticated instruments. Once raw material has been brought and is ready for use, its processing starts with the help of machines and the men on the floor.

12.5 Mixing: The basic objective here is to mix the different types of cotton together to take advantage of the desirable characteristics of each component in the mix. By a judicious blend of the different varieties, the mixing cost could be kept at a minimum and consistency in yarn quality between the seasons can also be maintained. Mixing for open end spinning may contain virgin cotton and waste (like comber nails, flat strips, roving ends, droppings, sliver bits and lap bits).

12.6 Usually, a purchase register which records all the purchases with the details of quality, and variety, weight and ex-mill cost of each bale is maintained. An Issue Register is maintained for issue of raw material to the mixing department. Yet another register is maintained for insurance purposes for arriving at the stock on hand at a particular time with the details of storage place.

12.7 Usually, mills adopt moving average cost or lot-wise cost method for arriving at the value of the Issues and the stock on hand. As the mills maintain lot wise register on the basis of their arrivals, it is easy to identify each lot and arrive at the cost of each lot (usually a lot contains 55 fully pressed bales). The closing stock also is maintained at cost on the basis of the cost of each lot.

13. BLOW ROOM

13.1 The essential functions of the blow room are to:

a. open the cotton into loose mass;

b. clean the cotton by removing the trash, seeds, leaves etc.; and

c. deliver the cotton in the form of a reasonably uniform sheet rolled into the form of a lap which facilitates easy handling in the subsequent process.

13.2 The cotton bales are opened in the 'bale breaker' in which hard compressed slabs of cotton are broken into a fluffy state. Thereafter, different types of cotton which have been mixed in calculated proportions to obtain the particular quality or count of yarn are put in the 'opener'. Here, the mixing is done. The mixed cotton is then folded into a sheet form called 'lap'. For processing man-made fibre, there is a provision to bypass the beating points.

13.3 The laps produced are designed to have a pre-determined weight per yard. Hence all the laps should have the same weight within allowable tolerance. Any serious deviation in lap weights will result in variation in yarn count which is undesirable. The mills maintain a lap register indicating the production of laps and their weights

14. CARDING

14.1 The maxim "to card well is to spin well" emphasises the importance of this process. The function of this process is to open the lap, separate the fibre, remove the impurities and short fibres in the lap. This is done by subjecting the fibres to the action of a large number of metallic wire points. Here, the end product is delivered in the continuous form of a 'sliver' (resembling thin ropes of cotton) deposited into a vertical container namely sliver can for feeding the next process *viz.* drawing/ combing. The important parameters in this are the flat speed and the allied settings as the removal of short fibres is dependent upon these factors.

14.2 Usually the mills maintain a register of production of sliver cans by each carding machine. For producing quality yarn, it is necessary to periodically grind the metallic wire and flat tops.

15. PREPARATORY PROCESS

All subsequent processes after carding are for the following objectives:

a. To lay the fibres parallel which will facilitate drafting and yield uniform yarn;

b. To achieve uniformity in weight per unit length by the necessary processes; and

c. To attenuate or draft the sliver into thinner strands at stages to achieve the desired ultimate yarn count.

16. COMBING

16.1 This operation is an optional one. Usually yarns are produced in carded form (without going through this process) or in combed form. Previously, foreign cotton needed for production of fine yarns such as 80, 100 and 120 used to be combed but now even Indian cotton is also combed. This is an expensive process. It reduces the output of yarn from cotton. Hence, it is gone through only if the selling price is remunerative. Usually other raw materials are not combed.

16.2 The fibres are combed by means of a rotating cylinder, having a number of pins. The sliver obtained from Carding department are passed through pairs of drafting rollers. This helps in parallelisation of fibres. The resultant sheet of fibres is wound on a spool (sliver lap). Six such sliver laps are passed through a series of pairs of drafting rollers. This helps in parallelisation of fibres and six sliver laps fed are combined into one ribbon lap. This ribbon lap is next fed into another machine, where the sheet of fibre is gripped firmly between a pair of nippers, over which the combing cylinder passes, removing the short fibres of less than a preset length. The sliver is coiled in vertical cans for feeding the next process-drawing.

17. DRAWING

This process passes multiple carding sliver through a series of pairs of rollers, moving

at progressively increasing surface speeds. This helps in parallelisation of fibres, removal of hooks, regularisation of weight per unit length. Normally, two passages of drawings are employed but depending upon the requirements of the end product, use of three passages is also adopted.

18. SPEED FRAMES

18.1 The sliver received from the Drawing department is passed between pairs of rollers. The object of this process is to reduce the draw frame sliver to a size suitable for final spinning by employing necessary drafts. The strands thus produced are given a slight twist by the machine to obtain cohesive strength. The resultant material, called roving, is wound on a plastic bobbin.

18.2 The conventional systems used either two or three pairs of speed frames called slubber, inter and roving where the drawing sliver was drafted in stages. However, with the development of apron drafting systems it is possible to employ high drafts both in speed frame and ring frame. Hence, modern spinning sequence uses only one stage of roving generally called **can-inter**, thereby reducing process costs.

19. RING FRAMES

This is the final stage of process in which the raw material is converted into yarn. Depending upon the count to be spun, drafts are employed and the delivered strand is imparted necessary twist. The amount of twist to be put is decided by the quality of cotton and the end use of the yarn. Yarn meant for warp in fabrics is generally twisted more because it has to withstand a lot of stress and strain in further processes whereas yarn meant for knitting or hosiery for manufacture of banians etc. is generally soft spun with less twist necessary to get soft feel and fullness in knitted garments. Finally, the twisted strand called yarn is wound around a slim bobbin. The amount of twist put and the speeds in spinning play a significant role in the manufacturing cost.

20. OPEN END SPINNING

20.1 This is a new development for production of yarn by replacing speed frame and ring frame department. Here, the drawing sliver is separated into single fibres by means of a saw toothed or pinned roller called 'opening roller' and thrown on the circumference of a rotor rotating at a high speed of over 50,000 rpm. The fibres are deposited on the collecting groove forming a fibrous ribbon which is then doffed at the yarn forming point, and is collected on a tube to form a cheese.

20.2 The advantage of open-end spinning is the huge production as well as use of comber waste and flat strips along with virgin cotton, thereby substantially reducing the manufacturing cost.

21. COTTON INPUT AND OUTPUT

The cotton fed into the blow room undergoes various processes. In each stage, loss of material takes place in the form of waste. This waste varies from mill to mill because of the machinery conditions, the quality of cotton, and the end product. Coarser counts are produced with cheaper variety of cotton. Hence waste is higher compared to fine counts that are produced with superior cotton. In the output statement for spinning, only the salable waste is considered for calculating the invisible loss. The usable waste collected is normally reused, in which case it need not be considered. Otherwise, it should be. Wherever yarn is conditioned for improving its quality, weight gain takes place and the invisible loss comes down. For monitoring and controlling of wastes the waste collected is analysed, and percentage of waste at various stages is calculated variety-wise.

22. POINTS FOR INVESTIGATION

22.1 The P&L account of the spinning mills shows:

a. Direct cost: Value of cotton consumed, wages, stores consumed, fuel power.

b. Indirect cost: Salary, interest, repairs and renewals, commission, transport and other administrative expenses.

c. Other issues to be looked into–Govt incentives such as capital/ interest subsidies, tax saver schemes, income/ loss in Future Contracts.

d. Genuineness of claim of additional depreciation

22.2 Cotton Purchases: Usually cotton is purchased on contract basis and a contract book is maintained showing the serial number of the contract, the date of the contract, the names and addresses of the parties concerned, the quality and quantity of cotton contracted, and the rates and period of delivery, etc. It is a common practice that certain percentage known as 'cut' is secreted out of the Purchase account and pocketed by the Directors. An investigator has to look into the market indicators and various parameters in the cotton market such as reduction in supply of yarn.

22.2.1 Case Study: In one search case of Saurashtra region, it was found that around Rs. 1300 crores of URD cash purchases of cotton was made over a period of 6–7 years from 2 parties, who in turn had claimed to have made purchases from farmers/ cultivators. Further it was found that assessee had claimed all these cash purchases exceeding Rs 20,000 as business expenses in light of the provisions of Section 40A(3) r. w. Rule 6DD(e). It is noteworthy that Rule 6DD(e) grants immunity from the provisions of Section 40A(3) only if cash payments in excess of Rs 20,000 are made to the cultivator, grower or producer for the purchase of agricultural produce. On enquiry, the said parties merely informed names of numerous persons and their villages along with amounts paid to them. Thereafter, details of the persons from whom such purported cotton purchase was made in cash, were called for from Revenue Authorities about their land-holding/ farm produce data etc. as also their names were checked from Electoral register which was updated in view of impending state legislature elections. The enquiries revealed as under:

a. From the analysis of land revenue records, it came out that out of a total of 1602 URD purchase parties verified in the land records, 963 persons didn't possess land in the respective villages.

b. On analysis of the electoral data it emerged that out of 794 URD purchase entries whose electoral records were retrieved, 484 names were non-existent in the respective villages which the assessee had recorded against their names in its books of account.

Thus, in percentage terms it turned out that 60% of the purchase parties were non-verifiable from the land records as well as electoral records of the respective villages. Accordingly, these parties were actual cultivators or not could not be established and hence, proportionate disallowance was suggested and substantial amount was proposed to be added *u/s* 40A(3) on this count.

22.3 Wages: Wages have a direct relation to the quantity of yarn produced. While checking expenses on wages, figures of earlier years may be compared with the relevant year in relation to production and abnormal variations, if any, be properly scrutinised. Generally, the textile industry is in the process of modernization, which results in reducing the manpower and wages. The AO may see if expenses on installation of sophisticated machineries are commensurate with the reduction in wage bill.

22.4 Stores Consumed: The expenses on stores, and on fuel and power have a direct bearing on the cotton consumed. The reasonableness of these expenses should,

therefore, be examined with reference to the quantum of cotton consumed. The figures for one year may also be compared with those of earlier years, in comparable cases. Where the component of stores consumption in the cost of production is high, it may be necessary to obtain comparative details of the quantity and value of certain selected items of stores consumed for different accounting years, as this will reveal the items in which there has been a substantial increase. A pursuit of the purchases of such stores may result in detection of inflation in those items. In one particular mill's case, stores purchases were inflated. On investigation, it was noticed that no purchase was actually made. The Internal Auditor managed to get bogus vouchers for purchase of stores.

22.5 Sales: In a spinning mill, the main item of sales are yarn and cotton waste. Generally, the yarn produced is subject to excise duty and as such there is control over production and dispatches by the Central Excise authorities. However, while assessing a spinning mill, it is necessary to verify and reconcile the quantities of yarn produced, with those sold and dispatched. In some cases, verification of the dispatches of yarn, recorded in the 'gate pass book' revealed double numbers in the gate passes showing dispatches of additional bales without being brought in the books. Sometimes, it is also found that the mills have sold yarn at rates which are less than the prevailing market rates. It is, therefore, necessary to compare the selling rates of the quality of yarn sold on particular dates with the prevailing market price.

22.6 Wastage: In this industry, invisible wastage is normally between 1.5 to 2.5 per cent. In the case of use of method of Comber, invisible wastage may be a little more. Post-industrial waste is the material left over from the production. The material can be cutting leftovers, roll ends, overproduction and rejected fabrics.

22.7 Sale of Waste, Scraps, etc.: In a leading textile group, during search operations, it was found that the Directors used to collect extra money on sale of waste, scraps and to inflate wages account and as a result, cash more than Rs. 2 crores was seized. To unearth this practice, only search or survey will be useful. Scrap sale of such waste needs to be examined with the industry standards and the output/ yield ratio of the assessee generally achieved over the years. If the quantum claimed is relatively excessive, one needs to probe further into the matter.

22.8 Final Output: Yarn realisation is generally between 80 to 88 per cent of the cotton used and in the case of open-end spinning, the percentage range is 70 to 75 per cent.

22.9 Repairs and Renewals: During in modernisation process of textile mills replacements mostly of full items of machinery take place. These replacements are capital in character. However, often the assessees claim that the expenditure as revenue. In this effort the following propositions are conveniently forgotten:

a. Machinery does not cease to be machinery merely because it has to be used in conjunction with one or more machines. Nor does it cease to be machinery merely because it is, for instance, installed as part of a manufacturing or industrial plant.

b. "Broadly speaking, outlay is deemed to be capital when is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment." (Lord Sands)

22.9.1 The arguments against holding such expenditure as revenue are many:

a. The new machinery will lose its character as a capital asset consequent to the artificial allowance of the cost incurred on it as a revenue expenditure. This violates the definition of 'capital asset' in Section 2(14) and of 'block of assets' given in Section 2(11).

b. It leads to an unacceptable situation where a revenue item is created either by an admixture of capital and revenue assets or only revenue assets (when all the old machineries are replaced).

c. A capital asset does not get expended on revenue account either at the time of its acquisition or in the course of production.

d. Section 43A mandates that exchange rate fluctuation on making the payments relating to an asset acquired outside India should be adjusted in the actual cost of the asset as per Section 43(1) of the Act. If the cost of the asset is allowed as revenue expenditure, the exchange rate fluctuation has to be treated as capital expenditure, resulting in an abnormal situation wherein part of the value of the machinery is revenue and the other capital. This cannot be logical.

e. The Income-tax Act, the Accounting Standards of the ICAI, the decisions of the Supreme Court and lastly the commercially prudent policies adopted by the assessees themselves while computing the profits and declaring dividends, do not envisage a situation where final salable product is manufactured by a mixture of capital and revenue assets or by revenue assets themselves.

22.9.2 While faced with this situation the AO should not confine himself to the legal aspects alone. In fact, success depends largely on marshaling the facts and bringing them out in the order. The particular machinery may be inspected, its functions studied and the AO may come to a conclusion whether such replacement is capital or revenue. After drawing a proper conclusion, assessment order may be passed citing appropriate case laws.

22.9.3 The purchase bills for machineries may also be analysed. In a case, one machinery was said to have been purchased from a place which is not known for textile machinery. On further investigation, it was found that it was a bogus purchase.

22.10 Modvat/ GST Credit: In one case, it was noticed that the MODVAT credit taken was credited to stores purchase account. But when stores consumption was accounted in the P&L Account, the stores consumed were valued at cost including excise duty. Thus, the stores consumed was shown at an inflated figure. Hence, it is always better to analyse modvat (now GST) credit and to find out whether it is properly accounted in the P&L Account.

22.11 Additional Depreciation: During scrutiny proceedings in a case, it was found that certain notices issued to the transporters, supposedly involved in transport of new machinery purchased, had returned unserved. It was also observed that, in some cases, the transport challans were not complete and seemed to be spurious, i.e. in same handwriting on challans issued by different transporters, irregular serial numbers, etc. The directors of the entities, from whom assessee had claimed to have purchased the machineries, were examined on oath wherein they admitted that they had sold second hand machineries to assessee company but they had attempted to show the same as new machinery at the behest of the assessee. The assessee on being confronted with the said facts, admitted that the machineries were not new but rather were second hand and therefore the claim of additional depreciation was disallowed in the Assessment proceedings.

23. WEAVING MILLS

23.1 The Warping Process: Many cotton textile mills weave the yarn spun by them into cotton fabrics. Weaving consists in converting the yarn into fabric. The yarn supplied to weaving mills is in cones of weights of 1.5 to 2 Kgs. To construct a fabric, this yarn needs to be converted from cone to sheet form.

23.2 The cloth to be woven has two major components of yarn called the **warp** (the lengthwise yarn) and the **weft** (the breadth wise yarn). A part of the cones from the spinning Section is sent to the pirn-winding department to make pirns which go to the weaving shed for making the weft yarn. The conversion of cloth demands the warp ends to be prepared in sheet form by arranging the cones in a creel. As many as 650 to 800 ends are taken from the creel and wound on to a beam. This is called warping. Electronic sensors are provided to detect yarn breaks during the process for rectification.

24. SIZING

To overcome the strain of warp ends during cloth formation on the loom, the yarn is given a protective coating, called sizing. Sizing is done by applying starch-based adhesives to the yarn in sheet from, with proper drying arrangements. The width of fabric determines the number of warp ends to be sized. The beams are arranged one behind the other in tandem to deliver the designated warp ends of the fabric to be sized. The sheet of warp ends are immersed in the size mix and squeezed to remove excess material and taken over a series of hot cylinders for uniform drying. In this process, called 'size retention', the warp yarn gains weight. The size retention is about 40 per cent of the sizing materials used. The mill is expected to maintain a **sizing register** and a **waste register** which record the weight of the sized yarn and the wastage.

25. FORMATION OF CLOTH

The beams of sized warp yarn are then transferred to the loom shed for weaving. This final stage of weaving consists of three steps:

a. the division of the warped yarn and lifting/ lowering of its strands, so that the weft or cross thread may be interwoven or interlaced between them, known as **shedding**;

b. the insertion of the weft or the cross thread, known as **picking**; and

c. the striking of each weft thread into its appointed position in the fabric, known as **beat up**.

26. CLOTH VARIETIES

The cloth produced is divided mainly into four categories *viz*. coarse, medium, fine and superfine. The output of medium and coarse cotton fabrics ranges from 40 to 50 yards per loom per shift, whereas the output of fine and superfine cotton fabrics vary from 32 to 40 yards per loom per shift, although the output varies according to the quality of cotton used. Generally the production of coarse cloth works out to about 2.7 yards, medium about 4.8 yards, fine about 5.2 yards and superfine about 8.5. yards per pound of yarn consumed. Where there is defect in the manufacture, the defective cloth is sold separately as seconds, rejects, rags, and chindies.

27. BOOKS MAINTAINED

The design of the texture, the width, the weave and the pattern of the cloth are all determined by the weaving master before weaving commences on the loom. The cotton fabric emerging from the looms is called gray cloth. Each weaver is paid on the basis of the gray cloth woven by him, which as it comes out of the loom is immediately recorded in a '**pick production book**', weaver wise. This is the initial record in the factory, for cloth production. In most factories pieces handled by weavers are also weighed and the weight recorded, in addition to other particulars, weaver wise, and loom wise, in a production account termed '**kanta register**'. Thereafter the gray cloth is transferred to the folding department where it is actually measured mechanically or manually, rejecting defective pieces. The correct yardage or meter length is then recorded in the '**output book**' from which the daily production report is prepared,

showing quality wise manufacture of all cotton fabrics. This corresponds to the daily production statement in the spinning section. If the cloth is to be marketed in its gray condition, it is subjected to calendering, stamping, packing and baling. In most of the mills, the gray cloth is subjected to further processes before marketing. These include bleaching, dyeing, printing, mercerising and 'sanforising'. Thereafter, the pieces are folded and sent to the stamping department where the trade mark is stamped on each piece.

28. TAX INVESTIGATION

28.1 Production: It is necessary to reconcile the production of cloth with the consumption of yarn and the consumption of sizing material. The sizing retention is usually about 40 per cent of the quantity of sizing material consumed. On this basis, the yarn consumed can be worked out as under:

Weight of sized yarn	= a
Add: Weight of wastage produced in sizing	= b
Less: Weight of unsized yarn	= c
Difference, being size given to warp	= d = a + b-c
Percentage difference	= (d x 100)/ c = m
Less: Size retained at 40% of d/c x 100	= 40 d/ c
Net weight of yarn in cloth	= m - 40 d/ c
Add: Weight of weft yarn produced in weaving	= n
Yarn consumed in cloth produced	= m - 40 d/ c + n

This figure of yarn consumed i.e. (m - 40d/ c + n) should then be compared with the actual yarn consumed. If there is a variation the reasons have to be enquired into.

28.2 Another method of reconciling **the yarn shown as issued for weaving** and **the cloth manufactured** is as under:

Adjusted production as per RG 1 (now GST) register	= Production as per RG 1 (now GST) (+) closing stock of cloth in process (-)opening stock of cloth in process
Opening stock of yarn in the weaving shed	= a
Yarn issued to weaving	= b
Closing stock of yarn in the weaving shed	= c
Actual yarn consumption	= (a + b)–c

This actual consumption is then to be compared with the standard consumption.

Standard consumption = adjusted production as per RG-1(now GST) register x standard yarn consumption per yard

28.3 Where quantitative details of the sizing materials issued are not available the test should be to see whether the 'output statement' reveals any sizing retention at all. Normally the total on the right hand side of the above table should be more than the total in the left hand side, and the excess represents the size retention. If no gain due to size retention is recorded, it may indicate inflation of yarn issued or suppression of cloth produced or manipulations in the closing stock in the process.

28.4 A quantitative tally should be made showing the cloth produced, issued and sold. This can easily be found out from the Central Excise records. The output of cloth can also be checked with reference to average production per loom or the production per pound of yarn consumed on the basis of the average given earlier. But this is only a rough check and if wide deviations come to light a deeper probe may be required.

28.5 The following records/ registers are generally maintained and need scrutiny:

a. Sizing register

b. Waste register

c. Weaver wise production book, and Kanta register

d. Daily production report Output book

The following verifications should be done for a meaningful investigation:

a. Reconciling of cloth with reference to yarn and sizing material consumed.

b. Quantitative tally of cloth issued and sold should be verified from Central Excise Register. Overall production should be checked with the Average production per loom or per pound of yarn consumed.

29. KNITTING INDUSTRY

Knitting: Hosiery goods are manufactured in various parts of the country. Tirupur in Tamilnadu is the major centre of this industry. The town is known the world over for hosiery manufacture and exports.

30. MANUFACTURING PROCESS

30.1 In cotton hosiery, cotton yarn is the main raw material. The cotton yarn is supplied by various spinning mills. Cotton of long staple is imported from America and Egypt to manufacture super fine cotton yarn. The yarn comes in various counts. Usually, single count of yarn of 8 to 60 is used for manufacturing T-shirts, undergarments, ladies garments, nighties, sports wear, etc. The double count yarn is used for manufacturing collars, cotton sweaters, etc. Double count yarn is considered finer than the single cotton yarn e.g. yarn of 2/ 60 count is finer than the yarn of 1/ 30 count.

30.2 The spinning mills supply either the grey yarn or the dyed yarn. Grey yarn is suitable for single colour garments and the dyed yarn is suitable for multi-coloured garments. The spinning mills supply yarn on paper cones. For dyeing, the grey yarn is first **wound** on steel cones, and is then dyed. It is then dried in the dryer, and **re-wound** on paper cones. The dyed or the grey yarn is then knitted on circular knitting machines. If the cloth has been knitted on dyed yarn, it is washed and calendered (pressed). In case the cloth has been knitted from grey yarn, the knitted cloth is sent for dyeing. Some overseas buyers insist upon the manufacturers to dye the yarn before converting into fabric. The latest development in dyeing is the introduction of computerised dyeing machines which ensures dyeing in correct shades. The bleached and dyed fabric is then subjected to steam calendering, a process in which the fabric is passed over hot rollers to remove wrinkles. Nowadays, compacting machines are steadily replacing the calendering machines. These machines ensure uniform width of the fabric and also minimise shrinkage. The processed cloth is then cut into the required sizes and shapes. Stitching and labeling make the goods ready for dispatch.

30.3 In cotton hosiery, knitting is done on circular knitting machines. Most of these machines are imported. The machines imported from Germany & Italy are expensive and produce cloth of finer quality. The machines imported from Korea, Taiwan, China are cheaper but the cloth manufactured by these machines is not of very fine quality. The price of the imported circular knitting machine varies between 15 lakhs to 80 lakh depending upon the extent of computerization and other facilities available in the machine. The quality of the fabric depends upon the various factors like the quality of raw material, type of the machine used for manufacturing and the skill of the labour.

30.4 The units which undertake all the manufacturing processes are known as composite units. A majority of the manufacturers of hosiery goods prefer to outsource the various processing.

30.5 There is a significant difference in the business outlook of export units and the units which manufacture goods for domestic consumption. The export units are customer-oriented. They first procure orders from overseas buyers and get samples approved, and then start procuring the raw materials. The domestic manufacturers manufacture goods according to local fashion, in standard sizes and patterns. Their procurement of raw materials does not depend on orders.

31. EXAMINATION OF ACCOUNTS

31.1 Inflation of Expenses: A widespread practice for suppressing income is to inflate the expenses on fabrication charges, bleaching and dyeing charges, stitching charges etc. A diligent analysis of input-output ratio may help the AO to find out the extent of inflation of expenses. Whenever goods are taken out for processing or goods are received back from processing, delivery notes are prepared either by manufacturer or by the person who does the processing. The scrutiny of delivery notes would be useful to ascertain whether the assessee had got the goods processed. Processing charges like dyeing charges vary depending upon the specifications. As there are no uniform rates the AO may find it difficult to analyse the dyeing charges. Rest of the processing charges have uniform rates and it would not be difficult to examine the correctness of the claim.

31.2 Suppression of Closing Stock: Units, other than composite units, send goods for processing. At any point of time, some goods will be with the processors. The manufacturers often do not take into account the goods in process in the closing stock. Method of valuation of closing stock should be consistently adopted by the assessee in accordance with the generally accepted accounting policies and should not be inconsistent with the law unless otherwise provided.

31.3 In export units, separate sheets of work-in-progress are maintained for each order. Normally, it takes about 40 days (in the case of a unit outsourcing the processing) for export units to execute the orders. The AO can check the order sheets. Many exporters indicate, for easy identification, the export order number in the bills received from processors. Crosschecking of bills with the export orders will bring to light the malpractices attempted in this regard. Analysis of purchase and expense vouchers for February and March with reference to the export order would be useful.

31.4 In the case of the manufacturers of goods for domestic consumption, the manufacturing process takes only 15 days as the approval of buyers are not required at every stage. The summer months are the peak season for the hosiery goods in India. Production of hosiery goods peaks in the months of February and March. The assessee is likely to have substantial work-in-progress as on 31st March. A low closing stock of work-in-progress or finished goods may require scrutiny.

31.5 Most of the hosiery goods are sold on consignment. Suppression of the stock of goods with the consignees is often resorted to by the manufacturers. The AO would do well to check the account statements from the consignees. Comparison of purchase of raw materials made during the last quarter of the previous year (January-March) with the output achieved would be very useful in ascertaining the correctness of the closing stock.

31.6 Suppression in Sale of Waste: Wastage arises at each manufacturing stage starting from the wastage of cones, the wastage at knitting stage (wastage of gray fabric), the wastage when the dyeing or printing are not properly done. In the semi finished stage, improper cutting and stitching produce wastage. Rejected pieces cannot be sold. In the case of a composite manufacturer, the AO can fix the sale of wastage at 1 to 2 per cent of the total

turnover of the manufactured goods. Invariably, the assessee may sell the waste and contend that the same is recycled. This needs to be properly examined with various factors or otherwise the scrap sales earned in cash would go unnoticed.

31.7 The manufactures who out-source activities such as dyeing etc. realise the cost of the rejects from the processors. The AO may verify whether the cost recovered from the processors is properly accounted for. There would also be sale of waste. This aspect also has to be examined.

31.8 The assessees may generally go for tax planning in such industry as there are various allowances in the form of additional depreciation *u/s.* 32, investment allowances *u/s.* 32A/ 32AC/ 32AD, deduction *u/s.* 80JJAA in respect of employment of new employees. Proper analysis of the compliance of the conditions stipulated therein should be closely examined to avoid any mischief and to see that the intent of the legislature is not overstepped.

ANNEXURE - 1

GINNING PROCESS

RAW COTTON/ LOOSE BAGS
GINNING MACHINE
REMOVAL OF SEEDS/ OTHER IMPURITIES
COMPRESSED BALES OF C COTTON

SPINNING PROCESS

COMPRESSED BALES OF COTTON
LOOSE COTTON
MIXING UNIT
BLOW ROOM
LAP
CARDING UNIT
SLIVER
DRAWING (PROCESSED SLIVER)
SIMPLEX (ROVING)
SPINNING (YARN)
YARN

PACKING OF YARN

YARN [SINGLE YARN/ DOUBLE YARN]
CONE WINDING
CONE
YARN
PACKING OF YARN
YARN [SINGLE YARN/ DOUBLE YARN]
CONE WINDING
CONE

CHAPTER 3

Handloom and Powerloom

1. HANDLOOM

1.1 Introduction: Industry Profile, Market Size, Major Players

1.1.1 The Textile industry occupies a unique place in our country. The Indian textiles industry, currently estimated at around US$ 150 billion, is expected to reach US$ 250 billion by 2019. India's textiles industry contributed seven per cent of the industry output (in value terms) of India in 2017–18. It contributed two per cent to the GDP of India and employs more than 45 million people in 2017–18. The sector contributed 15 per cent to the export earnings of India in 2017–18 and is the second largest employment generator after agriculture. India's overall textile exports during FY 2017–18 stood at US$ 39.2 billion.

(^Source: https:/www.ibef.org/industry/textiles.aspx)

1.1.2 India's textile sector comprises of four important segments *viz.:*

a. Modern textile mills

b. Independent Power looms

c. Handlooms and

d. Garments sector

It can also be classified into 'organized and unorganized sector'. The handloom and power loom industries fall in the category of '**unorganized sector'.** The organized sector is mainly technology driven and uses various machinery and equipments of production. The unorganized sector which forms the dominant part of this industry, is labor intensive. The hand loom and power loom industries are mainly under the unorganized Sector. The Handloom Export Promotion Council (HEPC) is a statutory body constituted under the Ministry of Textiles, Government of India, to promote the export of all handlooms products such as fabrics, home furnishings, carpets and floor coverings. HEPC was constituted in 1965 with 65 members, and its present membership is about 2,000.

1.2 Role of Hand Loom Sector

1.2.1 The Handloom Sector plays a very important role in the country's economy. It is one of the largest economic activities providing direct employment to over 65 lakhs persons engaged in weaving and allied activities. As a result of effective Government intervention

through financial assistance and implementation of various developmental and welfare schemes, this Sector has been able to withstand competition from the power loom and mill sectors. This sector contributes nearly 19% of the total cloth produced in the country and also adds substantially to export earnings. Handloom is unparalleled in its flexibility and versatility, permitting experimentation and encouraging innovations. The strength of Handloom lies in the introducing innovative designs, which cannot be replicated by the Power loom sector. Thus, Handloom forms a part of the heritage of India and exemplifies the richness and diversity of our country and the artistry of the weavers.

1.2.2 Though the machine age and mechanization sounded the death knell to Indian excellence in the field of cotton fabrics, the handloom Industry has displayed innate resilience and has survived the onslaught of the more efficiently organized mill industry and the decentralized powerloom industry. The handloom industry has passed through many vicissitudes in its long checkered career and has managed to exist and has been playing its role in the national economy.

1.2.3 A spectacular range of hand loom and silks is created by weavers across the country, from the Madras checks and Kanchipuram weaves of Tamil Nadu to Pashmina and Shahtoosh of J&K, from the **'tie-and-dyes'** of Gujarat and Rajasthan to the **'eri and muga silks'** of Assam.

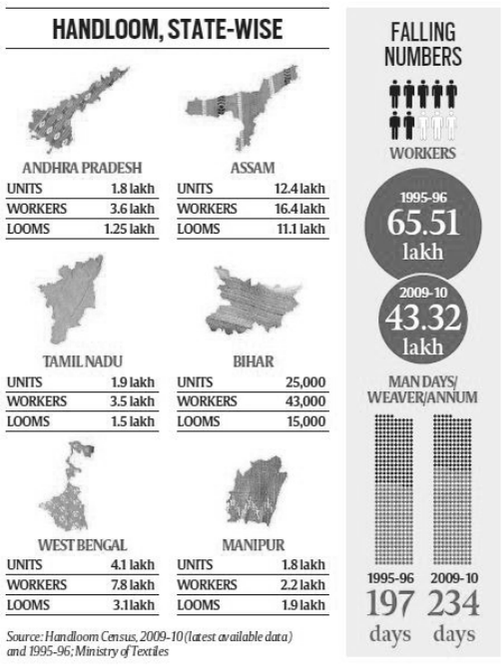
1.2.4 Handlooms constitute a vital sector of the village economy next only to agriculture. The number of handlooms in the country is estimated to be 3.8 millions scattered over the entire length and breadth of the country. 4.3 million people are directly involved in handloom production. Handloom industry is the 2nd largest employment provider in rural India after agriculture. 85% of world's capacity in handloom production is in India. India produces 1000 crore worth of handloom goods.

1.2.5 Handloom cloth is woven on looms worked by manual labour. It is a cottage industry and the looms are set-up even in the houses of the weavers. The middle man plays a vital role here. The usual practice in this trade is that, the master weaver employs several weavers. Yarn is supplied by the master weaver and the cloth woven by the weaver is taken back, and wages paid.

1.3 Key Markets and Export Destinations

The export of handloom products from India stood at US$ 357.53 million in Financial Year 2016–17. In 2016–17, the US was the major importer of Indian handloom products, with estimated purchases of US$ 100.08 million, followed by the Italy, UK and UAE at US$ 19.65 million, US$ 18.45 and US$ 18.18 million, respectively. Spain, Germany, France, Netherland, Australia, Japan, Sweden, South Africa, Greece Thailand, Chile, Sri Lanka, Belgium, Canada, Denmark and Norway are some other key export destinations. During 2016–17, export of fabrics stood at US$ 25.77 million, floor coverings stood at US$ 129.88 million, clothing accessories stood at US$ 20.27 million, and made-ups stood at US$ 181.61 million.

1.4 State Wise Production of Handloom



2. POWERLOOM

2.1 Introduction

2.1.1 Powerloom accounts for nearly 60% of fabrics and, because it is mechanized, works nearly 10 times faster than handloom. Costs differ, but the gap is massive: handloom can cost Rs 500/ meter to create, while the same fabric could be woven on a powerloom for Rs 30/ meter. The average investment in a powerloom industry could be Rs. 15,000 which is three times that of handloom.

2.1.2 India manufactures 5% of cloth through organized sector, 20% of through handloom sector, 15% through printing sector and 60% through decentralized powerlooms sector. The decentralized Power Loom sector is the life line of Indian Textile Industries. 2.43 million of powerlooms weaving 19000 million meters of fabric provide employment to 7 million workers. The industries now produce wide range of fabric, dyed fabric, cotton fabric, various mix of cotton, synthetic and other fabrics. The country exports to the tune of Rs. 44,000 million worth of goods to other countries like USA, France, Germany, UAE, Hong Kong, etc.

2.1.3 Most of the power loom units are concentrated into 'Semi urban or Rural area'. Among all, Maharashtra has the highest number of power looms (8 lakh units), Tamilnadu is second (5 lakh units), Gujarat ranks at third (4 to 4.5 lakh units). The city namely Bhiwandi situated 50kms from Mumbai is key textile Centre of Western India and has 1/ 3rd of country's total power looms and turnover of around Rs. 10,000 crore annually.

2.1.4 The earlier powerlooms were shuttle based which were slow. Now-a-days faster looms without shuttles are used. We have 45% of world powerloom capacity. However, in this industry we suffer from (i) obsolete technology, (ii) low value addition, (iii) unskilled labour and (iv) power shortage.

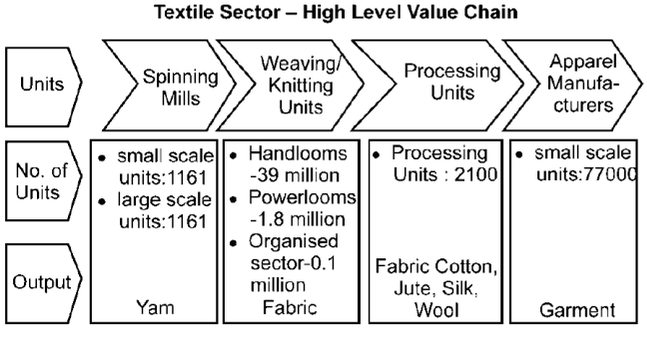
2.1.5 The process of liberalization opened-up Textile Sector to potential entrants. Besides eliminating the system of licensing, the Textile Sector was removed from the list of '**reservation**' for the small scale industries. In 2000, a new textile policy was announced by the Government of India, with an aim of modernizing the textile industry so as to meet the global competition and implemented in a time bound manner with the technology up-gradation fund scheme covering all manufacturing sectors of the textile industry. The policy relaxed the restrictions on foreign investment, foreign technology and foreign equipment to make the domestic industry more efficient and competitive.

2.1.6 Besides the textile mills, cloth is also manufactured by smaller units called '**powerlooms**' using indigenous looms run by power. The powerloom factories generally purchase yarn from spinning mills and weave various types of cotton fabrics. The powerloom weaving industry has undergone major changes in terms of modernization of machinery and technological upgradation of the process of manufacture.

3. BUSINESS OPERATION/ PROCESSES IN TEXTILE INDUSTRY

3.1 India's textile industry comprises mostly small-scale, non-integrated spinning, weaving, finishing, and apparel-making enterprises. The figure below depicts the overall value chain and the number and type of units within the industry.

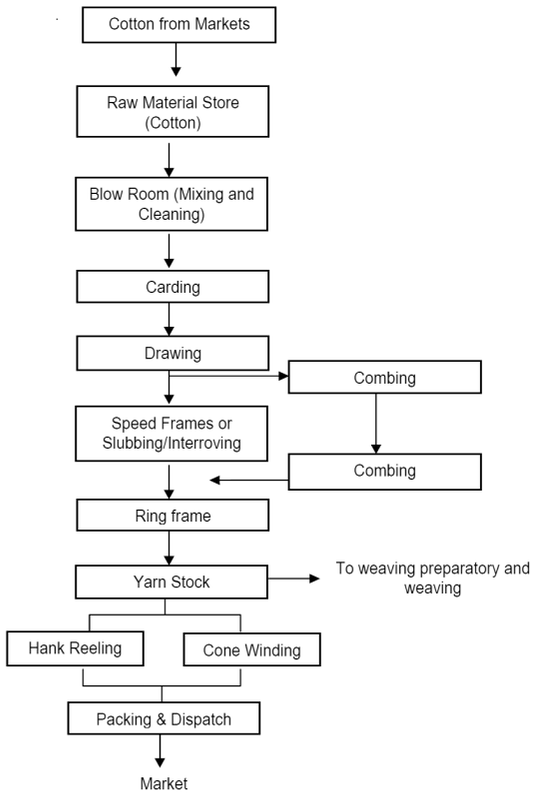
Textile Sector – High Level Value Chain



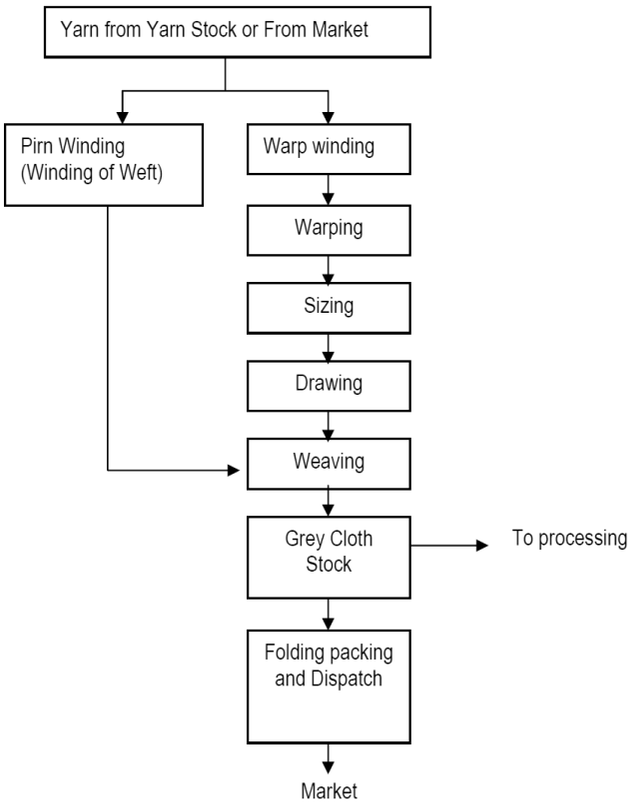
3.2 The various processes involved in the textile industry beginning from cotton fiber to final garment is shown in the flow chart:

a. Ginning: 'Ginning' is a process of cleaning the cotton fiber of impurities like cotton seeds, dust, grime etc. and straitening the cotton fiber, which is then pressed into bales and sent to spinning mills.

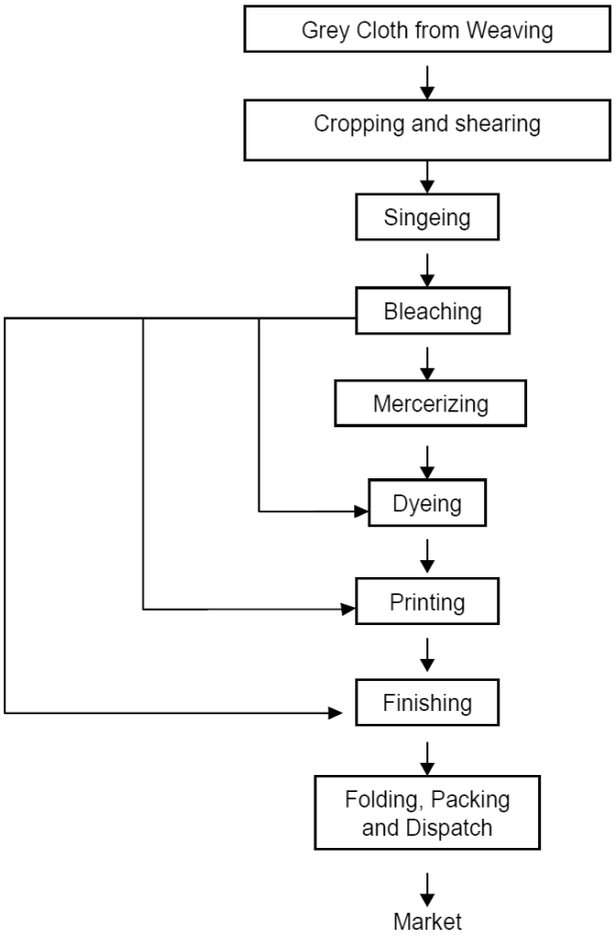
b. Spinning: 'Spinning' is the process of creating yarn (or thread, rope, cable) from various raw fiber materials. Several fibers are twisted together to bind them into a strong, long yarn. Characteristics of the yarn vary based on the material used, fiber length and alignment, quantity of fiber used and degreeof twist. Various types of looms are used like shuttle, air jet, water jet, rapier, projectile, dobby, jacquard and circular. Spinning involves a lot of processes which is given below:



c. Weaving: 'Weaving' is an ancient textile art and craft that involves placing two threads or yarn made of fiber into a wrap and weft of a loom and turning them into cloth. The yarn for weaving is of two kinds namely, (i) wrap yarn and (i) weft yarn. Wrap yarn means the yarn running length-wise in the cloth, and the transverse threads in the cloth are called weft. The wrap yarn should be stronger than weft yarn so as to withstand the stress and strain of shuttle movement at the time of weaving. This cloth can be plain (in one color or a simple pattern), or it can be woven in decorative or artistic designs, including tapestries. The following chart shows the steps in weaving process:



d. Processing of Cloth: The steps involved in processing of cloth is depicted in the flow chart below:



3.3 Textile Dyeing: In selecting the method of textile dyeing, the type of process used depends on several factors that include type of material like, fiber, yarn, fabric, fabric construction, garment, generic type of fibers, quality standards used in the dyed fabric, sizes of the dye lots, etc. Batch Dyeing Process is the most popular and common method used for dyeing of textile materials. Batch dyeing is also sometimes referred to as Exhaust dyeing. This is because in this process, the dye gets slowly transferred from a comparatively large volume dye bath to the substrate or material that is to be dyed. The time taken is also longer. The dye is meant to **'exhaust'** from dye bath to the substrate. In batch processes, textile substrates can be easily dyed at any stage of their assembly into the desired textile product. This includes fiber, yarn, fabric or garment. Some type of batch dyeing machines can function at temperatures only up to 1000°C. For example cotton, rayon, nylon, wool, etc. can be dyed at 1000°C or lower temperatures, while polyester and some other synthetic fibers are dyed at 1000° Centigrade or even higher temperatures. There are three general types of batch dyeing machines which:

a. where there is circulation of fabric,

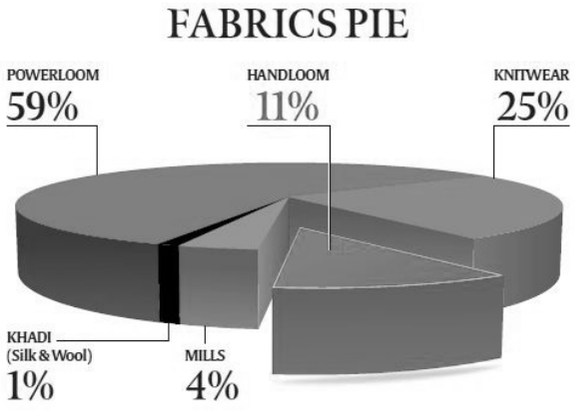
b. where the dye bath gets circulated while the material that is being dyed remains stationary,

c. where both the bath and materialto be dyed gets circulated. Examples of dyeing machines that utilizes batch dyeing process are Beck, Jet, Jigs, Beam Package dyeing machines, etc.

3.4 Garment Manufacturing: The Garment manufacturers are primarily engaged in the design, cutting and sewing of garments from fabric. Design and patterning is now done on 'CAD' and 'CAM' software. Some manufacturers are either contractors or sub-contractors, which generally manufacture apparel from materials owned by other firms. Some manufacturers are vertically integrated, producing the textiles from which, they make garments, or even operating retail outlets too.

3.5 The production of various types of fabrics is depicted in the pie diagram below:

Total Production of Various Types of Fabrics



4. TAX EVASION AND ACTION TO BE TAKEN BY THE INVESTIGATION OFFICER/ ASSESSING OFFICER

Tax evasion is a complex problem. Investigation of tax evasion is a challenging task requiring imagination, intuition, skill, aptitude and experience. Techniques of tax evasion become more and more complex as methods of detection become sophisticated. The various issues that need to be examined & verified to detect tax evasion are enumerated here-in-under.

4.1 Profit Ratios

4.1.1 The AO should compare the gross profit ratios of assesses having similar nature of business to check the correctness of profits. It is seen that industries of similar nature are concentrated in specific regions. For example, in Saurashtra region there are many ginning industries. Similarly power loom weaving industries are found in Bhiwandi and Surat and knitting industry is based at Coimbatore (TN). The books of accounts of the assessee which do not reflect the true state of affairs and incorrect GP and NP are shown by way of under reporting of quantity of stocks and over reporting of manufacturing cost. The AO should verify the stock and the expenses claimed by the assessee.

4.1.2 There should be reconciliation of raw material consumed and finished product produced. Further in case of power loom, to operate the same, permission from the Textile Commissioner is needed. All power loom units are under the supervision of GST officer of particular area. They are required to keep a register showing particulars of owner, location of factory, total number of looms, number of looms working on non cotton fabrics, name and address of master weaver. Similarly in case of master weaver the GST range office has to maintain a register showing name and address of master weaver, license number, location of work premises etc. The AO may go through this register to see whether a master weaver has disclosed all the production which he gets done through the other weavers employed for the purchase.

4.2 Bogus/ Inflated Purchases

4.2.1 Since more than 60% of the finished product cost consists of principal raw material i.e. cotton which is purchased in cash through farmers who generally do not maintain books of accounts or file returns. Hence, it is a common tendency of the assessee to show purchases at a higher price and overcast purchases. Cotton Association of India (CAI) is soon going to launch a 'CAI trader mobile app' for the benefit of all its members who deal in cotton trade. The app would help cotton traders with fresh market data about prices and arrival. In addition to data of BSE and MCX rates, the app will also give live data of USD/ INR exchange rate and ICE cotton futures price. The officers can also make use of such app to understand the general pricings and to evaluate the justification of the profits shown in the books.

4.2.2 Some of the manufacturers mix art silk yarn or blended yarns with cotton yarn and sell the product. Art silk yarn is obtained by getting import licenses. These Licenses are sold at premium and regular rackets flourish in the sale of this quota. In such cases, the production and sale account would be sham, there being no production or sale, the art silk licenses having been sold. Wherever an assessee is found to have purchased a license, his account should be taken up for intensive scrutiny. As the upcountry merchants purchase the licenses after payment of the premium, the enquiry should be to find out whether the manufacturer has utilised the license by:

a. Importing the yarn and paying for it,

b. Clearing the yarn,

c. Transporting the same to his place of manufacture, and

d. Utilizing the same in the business.

Liaison with the Controller of Import and Export, Customs etc. would be helpful. Expenditure account also should be scrutinized to see whether any 'bogus expenditure' is claimed.

4.3 Bogus/ Inflated Job Work Charges

The job work is mostly done in the unorganized sector and payments are made in cash through labourers who do not file returns hence there is common tendency to inflate the job work charges. There have been several instances of bogus job work payments. The investigation officers should verify the same. Beside GST is applicable to minimum turnover of Rs. 20 lacs so many of those parties doing job work do not file return. Thus the scope for inflating the job work expenses is high. The AO should examine the job work register, register of goods inward and outward and other circumstantial factors including place from which job work is carried out, mode and source of payment to job work, etc. Also, in order to increase the expenses the manufacturers book bogus or inflated job work expenses to related parties. The AO should minutely examine these expenses.

4.4 Over Booking Wages and Commission Payments

In some cases, wages and commission are inflated and huge advances are shown to be pending from the weavers. But, on examination these are found not to be true. Thus, where huge advances are shown contrary to normal practice, examination of weavers to whom such advances are made will be essential.

4.5 Stock Transfer

Where business is carried out through branches at various places, it is necessary to see that branch accounts have been reconciled with head office. The transfer of stock from head office to branch office should be invariably checked to verify the same and outgoing from the branch office.

4.6 Price Inflation

Some dealers purchase at discounted prices, finished products from the co-operatives and other handloom producer and resale them when the market conditions are favourable after inflating purchase price. Payment made as advances to cooperative societies and lorry receipts/ transport receipts are to be reconciled for proper date of booking the purchase.

4.7 Transfer Pricing

Multinational players in the industry transfer the goods at lower cost to their related/ associated concerns located outside India. The transfer pricing provisions although are applicable on such transactions, such company portray the price quoted by the other company in the same segment and justify the prices charged by them. Further, transfer pricing being a subjective issue also casts additional burden on the revenue to justify their stand. Therefore, proper verification with documentation is required to be done by Transfer pricing officer to stand the test of further litigation.

4.8 Capital Expenses Claimed as Revenue

As explained earlier, organized sector in the textile industry are technology driven considering the variety of machines engaged in the process. In major expansion or updation carried out by them the capital outlay is often shown as repairs and maintenance and claimed as revenue expense. Therefore, proper verification with documentation is required to be done in this regard.

4.9 Under Invoicing/ Suppression of Sale

4.9.1 As regards '**suppression of sales'**, it would be necessary to verify the sales with reference to the railway and road bookings. It would be useful to take contemporaneous extracts from railways stations and transport

companies as some cloth bales are booked by the master weaver against self address and railway receipts is usually sent to their agents stationed at various locations. The agents take money from purchasers and clear RR through bank and then sale bales. Very often such sales for which invoices are fabricated in different name are omitted from the books. Therefore, in respect of consignments sent by rail or road from the station where production Centre is situated if such extracts are taken and checked suppression can be unearthed. Registers of transporters should also be checked to find inflation in purchases.

4.9.2 Sometimes, inferior or substandard quality of production is shown as sold, whereas production is of standard quality. This practice is resorted to pocket the excess sale proceeds.

4.9.3 Common method of under booking sales is through offering heavy discounts generally named as "seconds"/ "quality defect". However, in reality the same is sold at retail counter in cash at full price. During the course of stock taking/ manufacture process, verification of such defective pieces as a percentage of total production to be compared on year to year basis for any major fluctuation.

4.10 Yield

4.10.1 The yield of the products from various type of looms varies depending on the type of the weaves and the mix of yarns used. In a typical case, the master weaver keeps a ledger account for such weavers showing the quantity of yarn supplied the quantity of cloth taken back and wages paid. The consumption of yarn and the production of cloth in such cases, as recorded in the assessee's book should, therefore, be compared with the consumption and production shown in the weaver's accounts. Where such ledger account is not produced, the only way to get at the information is to take resort to action under Section 133A and take into possession the ledger account and prepare an inventory which in time should be compared with the consumption and production shown in the weaver's accounts.

4.10.2 The cloth manufactured can be arrived at both in terms of weight and in terms of yards or meters. In a particular area there will be standard output of cloth either in terms of yards or in terms of meters with reference to every 1 Kg. of yarn consumed. Thus, if the output of a particular type of cloth is not upto the standard production shown in the accepted cases, it would be necessary to subject the accounts to a thorough scrutiny. The details regarding the estimates of fabric from khadi, wool and silk, can be collected from the O/o Khadi and Village Industries Commission, Wool Development Board and Central Silk Board respectively.

4.11 Wastage

Wastage is inherent in the different processes, therefore, its cost should be charged to the good units produced. The calculation of the cost of the finished product per unit for each cost centre is worked out after taking account of the wastage multipliers for the respective cost Centres. The waste multipliers are calculated to determine the quantity of raw materials required to produce one unit of the finished product. In the case of spinning activity, a waste multiplier is also known as the 'Yarn Equivalent Factor' (YEF). The formula used for its calculation for a cost centre is as follows:

100 - Total waste% (Upto and including the waste% at that cost centre)

100 - Total waste% in all cost Centres.

It may be noted that the total waste percentage in the above formula has to be based upon the input of the first cost centre. The calculation of the waste multiplier is illustrated below:

Mixing: 30s

Cost Centres Actual	Waste %
(i) Mixing and Blow Room	6.00
(ii) Carding	7.60
(iii) Pre-comb Drawing	0.80
(iv) Combing	10.10
(v) Post-comb Drawing	0.50
(vi) Inter-roving	0.50
(vii) Ring-spinning	2.50
	28.00

Thus, for carding cost centre the waste multiplier is

$$= \frac{100 - (6\ 00 + 7.60)}{100 - 28} = 1.2$$

If the per kg cost of yarn produced upto the 'carding' process is 'x' (before taking account of the wastages), the final per kg. cost of yarn produced upto the "carding" process can be determined by multiplying 'x' 1 with the waste "multiplier" for that process i.e. 1:2.

5. CONCESSION GIVEN BY GOVERNMENT

In recent years many primary cooperative societies have been formed at various production Centres and there is an apex body regulating the primary cooperative societies. Thus, Section 80P comes into operation in such cases and the income from this mostly gets deducted. The Department has, therefore, to deal with both manufacturers and merchants. The merchants may be either wholesalers or retailers. New issues like purchase of looms, their claim of depreciation, subsidy etc. needs to be verified.

6. GST RELATED TAX EVASION

6.1 As recently reported in the press the players of the garment industry employ the following innovative techniques of tax evasion of GST due to differential GST rates based on price, type of yarn, exemption given and structured faults of GST schemes.

6.1.1 Billing higher quantity of goods: A particular finished product of say a shirt costing Rs. 1200/- is billed as two shirts costing Rs. 600/-. Accordingly, they can claim twice the expenditure of related costs and reduce the profit

6.1.2 Using the same invoice three times: saree traders often use the same set of invoices to ship goods to other state. The reason why the same invoice is used is unknown but it is customary that the invoice is used three times and accordingly sales are under booked.

6.1.3 Simultaneous use of kacchha and pakka invoice which are destroyed if tax authorities do not check truck on the way is also a common trend in the industry.

6.1.4 Unlike goods moving by trucks, which are stopped on the way, there are virtually no checks in case of railways, making it easier to evade taxes.

6.1.5 The traders have started dispatching goods by railway instead of roads as movements of goods by trucks involve e-Bills (GST).

6.1.6 The investigation officers should verify these aspects. Beside GST is applicable to minimum turnover of Rs. 20 lacs so many of those parties doing job work do not file return. Thus the scope for inflating the job work expenses is high. To plug this problem the reverse charge mechanism has been introduced in GST wherein the buyer from unregistered dealers pays tax on the goods and services rendered by the job workers. However, the same was deferred by Government.

6.2 Under the 'GST regime' and even under previous excise regime the classification of output goods is done by manufacturer in such a way that it attracts the lowest rate of indirect tax. For example, under GST regime synthetic yarn and man-made fibre is taxable @ 18% & 12% whereas output fabric is taxable at lower rate of 5%. Hence the finished product is wrongly classified by the manufacturer and the rate applied is much lower than at the price it is sold.

The investigation/ AO officer should check-up the type of goods manufactured.

6.3 Products sold below Rs. 1000/- should be thoroughly verified. Further, bills made below Rs. 50,000/- are not subject to e-way bill. Special verification of bills or parties to whom repetitive bills of below Rs. 50,000/- are sent should also be made and if possible cross verification should be done.

7. CHECK LIST FOR AO'S AND SAMPLE QUESTIONNAIRE

7.1 Purchase of cotton (URD) purchases should be verified vis-a-vis MCX prices on that date. Upcoming trading app may also be relevant for this purpose.

7.2 Installed capacity details of unit should be called for and should be verified *vis-á-vis* actual production figures. The difference is clear indicator of suppression of sales. Electricity consumption, factory registers, engineer certificate, stock records, GST records etc can be relevant pointers to check the production carried out.

7.3 The AO should call for loan details and Project Report submitted to Bank *u/s.* 133(6) of the I.T. Act to verify the projected production and sales figures submitted to the bank which should be match with actual production figures. In case of high variation the same should be examined thoroughly.

7.4 Related party sales should be verified for pricing. Similarly related party purchases/ expenses claimed like job-work, commission etc are also inflated or are bogus. The AO should verify the genuineness of these expenses.

7.5 Sales show under invoicing or unreported sales. The AO should call for Transport Receipts, Railways Receipts, export Receipts and verify accordingly.

7.6 AO should compare Gross Profit Ratio, electricity consumption, lower/ wages charges, job-work charge with that of previous years and other assesses in the same line of business. Unusual ratio should be examined and such case be taken up for survey.

7.7 Repairs and Maintenance Expenses should be verified keeping in mind the various case laws as to whether the same is capital or revenue expense.

7.8 In case of 1st year of assessee or Capital expansion, the AO should examine the source of increase in capital by way of Share Issue/ Unsecured loans. Also in case of share premium the basis of premium calculation needs to verified, keeping in mind the provisions of Sec. 56(2)(x) of the I.T. Act.

7.9 Any wastage out of production activity should be factored properly with the yield ratio and general industrial trends and business practices. Many a times, wastages are recycled or sold in scrap. Relevant measures to check this aspect should be taken by the officer.

7.10 The Income-tax Act provides various benefits in the form of additional depreciation, investment allowances, profit linked deductions, employment linked deductions. It should be properly examined whether the claims of the assessee are genuine and necessary conditions have been complied with or not.

7.11 Considering the industrial profit margin, trend analysis and the overall market of this industry, the Officer should examine the records minutely to check whether there is any suppression in the profits offered to tax by inflating the expenses or reducing the sales or closing stock valuation.

7.12 Instances of showing higher profits in books and claiming deductions in Income-tax can also prevail in order to show rosy picture in books and simultaneously, also avoiding any tax implications as this helps the assessee to even avail higher finance assistance from banks, NBFC or any other financial institutions. The Officer should also monitor such transactions and check the genuineness thereof to avoid any defaults of payments to such finance lending companies/ banks as well.

CHAPTER

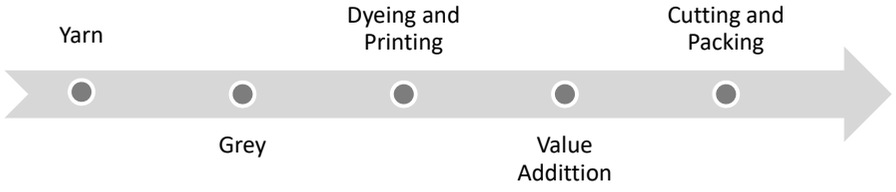
4

Process House

1. INTRODUCTION

1.1 A process house is an institution where colouring and finishing work is executed on gray cloth with the help of machines. It is an important limb of the textile industry. The demand for synthetic fabrics has gone up in India due to increase in population, direct and indirect exports, durability and low cost of the fabrics, besides several other favourable factors as compared to cotton fabrics.

1.2 Textile manufacturing is a major industry. It is based on the conversion of fiber into yarn and yarn into fabric. These are then dyed or printed and fabricated into clothes. Different types of fibers are used to produce yarn. Cotton remains the most important natural fiber. There are many variable processes available at the spinning and fabric-forming stages coupled with the complexities of the finishing and colouration processes to the production of wide ranges of products. There remains a large industry that uses hand techniques to achieve the same results. Any fabric, may it be a Saree, Dress, Suiting, Shirting is made up of yarn and has to typically pass through following process:



1.3 Yarn is the basic raw material for preparing any fabric. Yarns are manufactured from various natural and manmade fibres originating from cotton, viscose, POY and so on. These fibres passes through various processes like twisting, texturising, heating etc. and are manufactured into various grades, denier quality etc.

1.4 The yarn is then used by the weavers who weave the yarn into various types of fabrics. The process of weaving is carried out through Looms. Looms may be traditional Indian looms or high end technologies like rapier, water jet, electronic jacquard and so on. The cost of a typical loom may range anywhere between

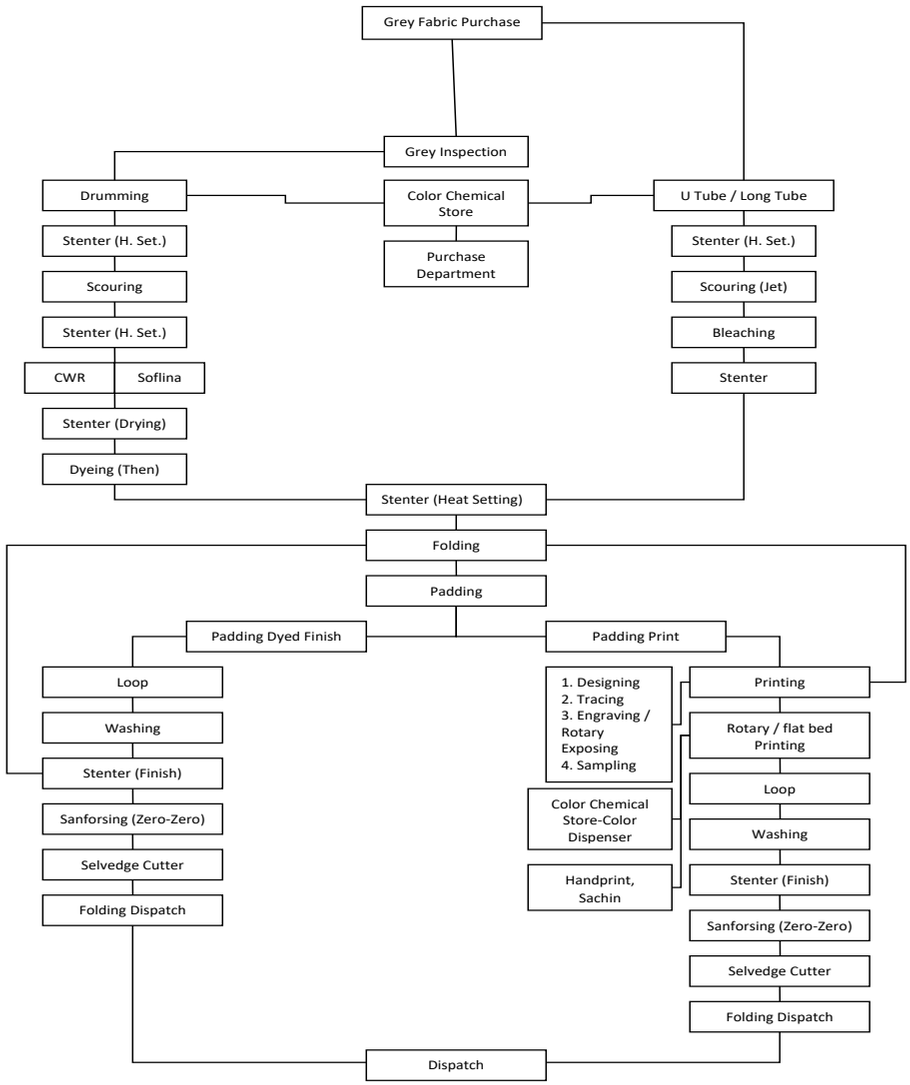
Rs 0.50 Lakhs to Rs 150.00 Lakhs and the industry may be categorised from cottage industry to large scale industry depending on the number and types of looms.

1.5 In all these processes the most complicated process is dyeing and printing. Grey fabrics, which are the coarse or raw fabrics, passes through various process of cleaning, softening, shortages, elongation and dyeing, printing, heat setting and so on. This part of textile processing is the most capital intensive part of the chain and uses the maximum number of raw materials and machineries in the process, transforming the raw fabric into finished and ready to wear fabric. Typically such units are called as process house.

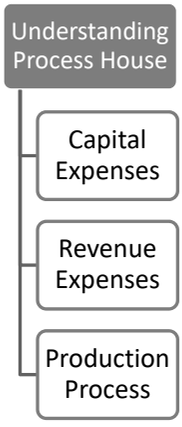
1.6 After the dyeing, printing and processing of fabric, the fabric are cut into various size depending upon the requirements of user like suit, saree, scarf, burka, duppata and so on. The ready fabric is now sent for value addition. Value addition may of various kinds like stitching of laces, stones, embroidery, garmenting, foiling and so on.

1.7 After the completion of the above stages, the fabric are then polished, packed, branded and despatched to various wholesalers spread throughout India and across globe through various means *viz.* road, railway and sea ways.

1.8 Out of the above processes, Process Houses are the biggest value addition chain and deploy maximum number of machines, processes, employees, raw materials and so on. The complete flow chart of production process can be summarised as below:



1.9 The production flow chart depicted supra, clearly show that there are number of processes involved in the dyeing and printing of fabrics. The whole process is a very complicated production method and not a line production. A piece of fabric may go more than once through the same production process. The process may elongate the fabric, shorten the fabric and change the colour of fabric, width of fabric or weight of fabric. From the view of tax investigation, the understanding of process house may be divided into capital expenses, production expenses and production processes as depicted below:



2. CAPITAL EXPENSES

2.1 The capital expenses of a Process House consist of following major heads:

a. Land

b. Building

c. Temporary Sheds

d. Plant and Machinery

e. Software

The above CAPEX are very important from tax perspective and contain some common verification points and some industry specific issues.

2.2 Involvement of Money in Land: In India it is a very common practice to pay cash over and above the recorded price for purchase of immovable property. Land forms a major part of investment in a process house. It is very difficult to detect such ON Money paid conclusively, except in search or survey actions, where some incriminating documents may be found. But in course of assessment also the valuation derived by the bankers for providing term loan to the assessee is a very important factor in deriving the value of land. In process house almost all the units take Bank Loans for availing benefits of subsidy available under TUF (Textile Up gradation Fund) and other state government scheme.

2.3 Building: A major part of unaccounted money may be Utilised in construction cost of the building in order to avoid payment of indirect taxes like VAT, Excise, Service Tax (Now merged into GST). Such evasions may be generally identified through the Valuers or obtaining of engineers report or putting some standard construction rates on the constructed area which may vary from Rs. 600 per sq. ft. to Rs. 1200 per sq. ft. depending on quality of construction, foundation laid etc.

2.4 Temporary Sheds: A process house raises temporary or permanent sheds from time to time for purpose of storage of raw material and establishing some ancillary machineries. Generally such sheds are not accounted for properly in the books of accounts. To avoid indirect taxes on materials, low rates item are shown to be used more in comparison of high rate items. Also cost of such sheds may be inflated to reduce the profitability of the company. Many a times cost of such sheds are also debited to repairs and maintenance expenses for reducing the profits.

2.5 Plant & Machinery: A process house uses various types of Plant & Machinery, which ranges from small to large, portable to immovable, mechanical to complex electronical, second hand to tailor made machines. Such heterogeneous mixture of non-standardised machines lead to a situation where finding out the cost of machineries, number of machineries

installed etc. becomes practically near to impossible. But one important aspect is the use of second hand machineries. In many cases, second hand machineries are bought at high cost to claim extra depreciation.

2.6 Software: A process house may use various type of software used in designing, R&D, Quality control, Process control and accounting. The accounting packages may be local accounting software or high end SAP. Generally the costs of such software are accounted in books of accounts. But the analysis of such cost throws a light on what type of software the assessee has purchased. Many a times, some software may be found to be purchased which are used in cloud computing, external hard disk and so on, which may be an important source of information for tax matters.

2.7 Subsidy: Textile sector receives various subsidies in form of capital subsidy or revenue subsidy, under TUFS, State schemes, Electricity schemes and so on. Various assessee may use various accounting policies in respect of timing, quantum and nature of such receipts. It may be treated directly as a capital grant and not passed through Profit and Loss account; it may be reduced from the cost of machines or it may be straight forward taken into revenue account. It may be booked at time of finalisation of amount or receipt of amount or on fulfilment of all the conditions of subsidy compliances up to the prescribed period of time. It is very important to note that any accounting policy must be in line with the ICDS guidelines. Now, due to the amendment in the definition of Section 2(24)(xviii) of the Act, assistance in the form of subsidy by whatever name called is invariably to be treated as income unless otherwise provided in said section. Thus, the major dispute which arose earlier regarding revenue or capital subsidy gets resolved and settled.

3. REVENUE EXPENSES

3.1 No Standard Recipe: In a process house various quality of fabrics are processed and in multiple methods. There may be wide variation in usage of colour, chemical, power, gas and other raw materials in processing of various types of fabrics. So, it is very difficult to assume in such circumstances as to the actual consumption of stock, but then also analysis of various qualities produced by the process house, its historical costing and current years cost incurred vis-a-vis the job charges collected, may throw a light on actual expenses. Comparison of financial data with cost records can be quite helpful in this regards.

3.2 Stock Register Not Maintained: Most of the process houses maintains proper stock of the inward and outward quantity of fabric produced in the process house. At the same time most of the process house do not maintain proper records of raw materials consumed in the complete production process and the same results into a big black hole for assessing officer to determine actual consumption of raw materials. Verification of secondary records/ books maintained by process house may be helpful in such circumstances.

3.3 Inflated Expenses: Both the above scenarios cumulatively provide a very conducive environment for any process house to inflate the expenses in form of raw materials. As it is virtually not possible to calculate exact consumption of raw materials, many a time cash purchases or bogus purchases are resorted for inflating expenses. Verification of Indirect tax records of suppliers and process house may lead to identification of black sheep in the books of accounts.

3.4 High Employee Turnover: Textile is one of the biggest employers in MSME segment in India. The majority of employees are unskilled and uneducated. Due to lack of awareness,

the labourers keep moving from one factory to another after collecting their wages daily, weekly or monthly and there is a huge turnover of employees in any process house. This huge turnover allows the process houses to show more man days of work done by any worker, who have left the job and inflate the salary and wages expenses. But after the demonetisation and recent instruction of Labour ministry, most of the labours are to be paid their wages or salary by cheque only. Under such condition cash payments to labourers may be an area to be focussed upon.

3.5 GST—The Game Changer

3.5.1 Before GST regime, the suppliers were covered under Vat or Excise. In both the laws there was no live monitoring on the existence or genuinity of the suppliers. The black sheep were identified at a much later stage when the indirect tax authorities were discovering that some suppliers were bogus and were not depositing the indirect taxes. Due to passage of time, such cases were handled by the Department under provisions of Section 147/ 148, which were quite litigative and time consuming. Now due to advent of GST the AO can check the inward credit register of the assessee and find which suppliers are depositing GST against invoices raised. This simple litmus test may filter majority of suppliers, who are genuine and let the AO concentrate on other suppliers who are not registered under GST or not depositing taxes regularly.

3.5.2 Further, the advent of e-way bill will be of great evidentiary value as the same will leave an online trail of movement of goods and make it virtually impossible for generating fake invoices etc. A cross matching of income-tax return with GST returns and e-way bills generated will result in segregating the bogus supplies from the actual one. A comparison of GST paid by various peer units may also throw a light on the integrity of the accounts of the assessee.

4. PRODUCTION PROCESS

4.1 As discussed the fabric process unlike any line process of manufacturing, moves in a very complex way with over-lapping processes and basically comprises of various permutation and combinations of complex processes, not providing any audit trails during assessment. Nevertheless the following points may be useful for assessment.

4.2 Energy Consumption & Job Bill: All the machinery used in process house is working on energy. The energy may be in form of electricity, gas or solar. It is the gospel truth that if the machineries will run more, the power consumed will be more and the job work billed must be more. So, a judicious analysis of the energy consumed and sales made may be helpful.

4.3 Production Capacity of Few Standard Machines: There are machines like Boilers, stenter, drum etc. which are invariably used for processing of any fabrics. Production capacity of such machines and cross matching of productions machine-wise, to the extent available, may be of great help for the assessment.

4.4 Shortage and Elongation: During process a fabric may be shortened or elongated from the original size and length, which may increase or decrease the invoicing of the process house. A smart analysis of various types of fabrics processed and nature of the fabrics may give very good results.

4.5 Wastages and TCS: Any process house may show more wastage to inflate the cost of production. Such inflation may be identified by historical data of the same assessee by comparing the historical data of wastages. Most of the scrap sold by the process house is liable for TCS. Analysis of TCS collected in earlier years in amount nature of scrap sold may be of great help.

4.6 SOP of the Process House: With the advent of technologies, most of the process houses have started using ERP, in which almost

the complete production processes are captured in computerised software. Understanding of the standard operating process of various units vis-a-vis the financial data may be the game changer in some cases.

5. IMPACT OF GST

5.1 Supply chain of Textile Industry is loaded with input and output across geographical and product boundaries to reach the ultimate consumer. Most of industry, being SSI, use 'Composition Scheme'. Numerous transactions in the textiles industry flow from the unorganized to the organized sector and vice versa. Where regular/ registered taxpayer purchases goods from 'composition scheme' taxpayers, they are not eligible for Input Tax Credit, thus breaking the CENVAT Credit chain. Input Tax credit paid on the previous transaction is included in the cost of the product, making the product costly.

5.2 This breakage of chain also leads to a great impact on direct taxes; due to non-linkage of buying and selling data. The breakage of trail of input and output produces grave challenge before the assessing officer to determine actual consumption in value and quantity. Also it leads to transactions not recorded in books as no trail is left behind. However, after the advent of GST, sweeping changes have been brought. The major changes which will be important for assessment proceedings are discussed below.

5.3 E-way Bill: A very novice concept of e-way bill has been brought in the GST. It mandates every movement of goods to be recorded online on almost real time basis. Matching of such data with books will be of great help in determining the actual sales and purchase of the assessee.

5.4 Reverse Charge Mechanism: In GST regime, any person having turnover of more than Rs. 20 Lakhs has to mandatorily take registration under GST. For small suppliers, the person taking the service has to pay GST on reverse charges. A micro analysis of payment made under such reverse charge mechanism may be helpful to curb the practice of putting small expenses to reduce the profit.

5.5 Credit of Indirect Taxes on Capital Goods: Till date, the process houses were not able to take credit of Indirect taxes paid on various capital expenditures. Under GST, they will be able to take credit on such capital expenditure other than immovable property. Taking of such credit will increase the profits of assessee, which may be ascertained.

5.6 Seamless Credit of All Indirect Taxes: As of now various taxes such as service tax, octroi, VAT, entry tax etc. were included in the cost of the assessee, as credit was not allowed against Excise of such taxes. But now the credit for such taxes will be allowed and this will increase the profits of the assessee.

5.7 An important effect of GST would be to improve compliance. The value chain under the GST will be fully traceable. As a result, ITC claims will have to be backed by full information chain of purchases and sales. Improved compliance will automatically lead to higher revenues.

5.8 So, it is evident that the process houses are a very complex form of production units with a heterogeneous type of machineries and process which give space for various tax leakages with very little or no audit trails. Finding out specific faults or cases of tax evasion, calls for innovative methods and deep data analytics on part of the assessing or investigating authorities.

6. VERIFICATION OF MAJOR INPUT WITH REGARDS TO PROCESS HOUSES

6.1 In a manufacturing operation based on chemical process, consumption of inputs provides a major area for investigation. In process houses, quantity of inputs is predetermined at every stage of processing. The AO must know the proportion of each input necessary to obtain the product at each stage. These ratios can be

used as standard to compare the actual in a given case. The Ahmedabad Textile Industrial Research Association (ATIRA) prepares a report on a cost-wise and region-wise comparison of inputs, productivity and damages in processing activities.

6.2 The consumption pattern of chemicals, colour, other material, water, steam, power and wages and salary in each manufacturing stage of process house are available in the report of the ATIRA and in the norms published by four textile associations (ATIRA, BTRA, NITRA and SITRA).

6.3 The AO may examine the reasons for variation between actual consumption and the standard prescribed by ATIRA taking into account efficiencies at each stage of processing. The internal records maintained by the manufacturer must be studied closely to trace the destination of consumption and output of the batch concerned. The quantity and value of inputs may be verified as under:

a. Ascertain the quantity of batch wise production.

b. Convert actual production as percentage of installed capacity and examine the reasons for shortfall in production compared to installed capacity. It will be necessary to take into account addition to production capacity during the year of account and in the preceding year.

c. Loss due to shrinkage may be examined with reference to norms of shrinkage. Similarly, loss of production capacity may be critically examined. Any abnormal reasons for low production/ loss of capacity/ idle time must merit special attention.

d. Co-relate production with the norms of consumption of water/ steam/ power and wages/ salary etc.

e. Reconcile the quantity of production with sales.

f. In appropriate cases actual production of intermediary processes must be compared with the capacity of the various manufacturing segments so as to ensure that the end product of one segment has been fully put through the succeeding segments and the final product obtained has been fully accounted for. The point to be noted here is that where the final segment has a higher capacity it is always possible to use that capacity to process intermediary processed clothes purchased outside the books of accounts.

7. CLUES FROM DETECTED CASES

7.1 In the case of a process house, the AO suspected excess consumption of colour and chemicals, shown at Rs. 3.8/- meter of cloth compared to Rs. 2.74 in preceding year. The AO detected bogus purchases of colour and chemicals of Rs. 56 lakhs, as also bogus processing charges in fictitious names.

7.2 In another case the assessee reported a shortage of 2.29% of cloth during processing. The Industry norms of shrinkage in processing were much lower. The assessee also claimed purchase of processed cloth for trading. These purchases were found to be bogus. It turned out that the production claimed as shortage was shown as purchases for trading (Rs. 41.65 lakhs).

7.3 Often a part of the production is not recorded in books of account. However, the assessees try to maintain ratio of consumption of various inputs to production. Where full production is not recorded in books, consumption of the corresponding quantities of inputs is also not recorded to avoid detection.

7.4 In a search case, it was found that the assessee had a generating set. In the books the use of generating set for running the plant was shown for a brief period. The plant was shown as running one shift on power drawn from Electricity Board. In fact, it was being run in two

shifts. A register was seized which contained details of day to day generation of power and consumption of diesel. With a view to maintain the ratio of consumption of power to production, the assessee ran the second shift exclusively on generator set. The corresponding expenses on diesel were not recorded in the books. A rough cash book seized from a director of the company showed that the actual purchases of coal and chemicals were far in excess of the purchases shown in the regular books.

7.5 Processing houses usually do job work as well. They receive raw-material, i.e. gray cloth, from their customers and, after processing it, return the processed cloth to them. A novel method of tax evasion was found in one case. The processing house A received **X** quantity of gray cloth for processing from a party B and returned the same quantity to B after processing. In its records, however, it showed the quantity as **Y,** which was only a small fraction of **X.** The quantity **Y** was shown as **purchased** from a fictitious party. It raised a bill for **sale** of **Y** in the name of B. Thus, the processing charge that was received from B for processing quantity **X** was shown as received as sale price of quantity **Y.** Thus, A depressed its profits. The receipt on account of processing charge was recorded in A's accounts as sale proceeds. However, A also debited its accounts for purchases of corresponding quantity of gray cloth. Of course, A must have incurred some unrecorded expenses on consumption of chemicals, coal, power, etc. This arrangement suited B also. B had to account for investment in only **Y** quantity that was much less than the actual investment made in quantity **X,** and the processing charges payable on that. In such a case, verification of the purchases, particularly those for which payments were either not made within a reasonable time or shown to have been made in cash, will help.

7.6 Understatement of processing charges is prevalent in this line. During a search, it was found that though the assessee was in receipt of processing charges @ Rs. 3.5 to 4.5 per meter of cloth (as indicated in the seized records), it disclosed only a rate of Rs. 2 to 2.5. It is useful to compare the processing charges shown as received by the assessee with that shown by other concerns. Particularly, the receipts shown by the public sector units will provide a good indicator.

7.7 Understatement of sale is resorted to depress income and to evade Duty. Excise Duty is chargeable on sale price of cloth. Action *u/s* 132 in a case led to detection of understatement of sale price by Rs. 6 crores. In another case, understatement of sale price by about Rs. 2 crores was admitted by the assessee. It is advisable to correlate quality-wise details of production and sale of fabric with the sale price of similar quality admitted by other manufacturers during the same period. If significant difference is noticed, it may call for deeper investigation.

CHAPTER

5

Hosiery Industry

1. INTRODUCTION

1.1 The history of textiles and garments in India dates back to around 3000 BC, as there is archaeological evidence of a cotton textile industry at Mohenjo-Daro in the Indus Valley. The diversity of fibers found in India, complex weaving on its manual but state-of-art looms and its organic dyes attracted buyers from all over the world for centuries. However, the British colonization of India and its industrial policies destroyed this innovative eco-system.

1.2 The modern hosiery industry in India came into existence with the setting up of a unit in Khidderpore, Kolkata in the year 1893 and has played a significant role in the industrial development since then. The hosiery industry reached its peak during the Second world war which become an important landmark in its evolution. After the end of the War the hosiery industry began to expand rapidly. Ludhiana, Tirupur, Surat, Delhi, Mumbai and Bangalore are presently the key Centres propelling constant growth to this industry. Numerous items of daily use made of woollen, synthetic, acrylic and cotton yarns are manufactured in these cities for domestic and global markets. Due to ever increasing population in the country, the domestic market for hosiery and knitwear items has always been the most important segment. Supplies to defence and paramilitary forces also play an important role in growth of this industry. The broad and well developed manufacturing and technological base in this industry has always prompted the entrepreneurs to enter the global market. The production of good quality cotton in our country, particularly in Punjab, is a plus point for boosting export of cotton garments. With the advent of the liberalized policies, modern and efficient machinery and equipments are being added to hosiery industry for the production of quality items commensurate to the expectations of the global customers. Presently, export of woollen, cotton and acrylic knitwear, fabrics and readymade garments from the country is the major source of earning foreign exchange.

1.3 India's hosiery and woollen industry has come a long way from being a cottage industry predominantly catering to the local community. It has now entered a new era in which the industry is able to meet international standards through constant innovation of techniques, styles, textures and colours. All wool and blended fabrics, cardigans, pullovers, mufflers, shawls, socks, gloves, garments, blankets are

being exported to various countries like the U.K., the USA, Canada, France, Italy, Germany, Kyrgistan, Ukraine, Kazakhstan, Saudi Arabia and Hong Kong. India's wool and woollen goods exports registered a spectacular growth in the last few years.

1.4 At present, the Indian textile industry is second largest after China, in terms of spindleage, and has share of 23% of the world's spindle capacity. It has been estimated that the Indian textile industry contributes about 11 per cent to industrial production, 14 per cent to the manufacturing sector, 4 per cent to the GDP and 12 per cent to the country's total export earnings. It is estimated to be providing direct employment to over 35 million people, being the second largest provider of employment after agriculture. Besides, another 54.85 million people are engaged in its allied activities. The fundamental strength of this industry flows from its strong production base of wide range of fibres/ yarns from natural fibres like cotton, jute, silk and wool to synthetic/ man-made fibres like polyester, viscose, nylon and acrylic.

1.5 The strong multi-fibre base of the industry in India could be understood by highlighting the following important positions reckoned by this industry across globe:

a. **Cotton:** India is second largest cotton and cellulosic fibres producing country in the world.

b. **Silk:** India is also the second largest producer of silk and contributes about 18 per cent to the total world raw silk production.

c. **Wool:** India has the 3rd largest sheep population in the world, having 6.15 crores sheep, producing 45 million kg of raw wool, and accounting for 3.1 per cent of total world wool production. India ranks 6th amongst clean wool producer countries and 9th amongst greasy wool producers.

d. **Man-Made Fibres:** India is the fourth largest in synthetic fibres/ yarns globally.

e. **Jute:** India is the largest producer and second largest exporter of jute goods.

1.6 The Indian textile industry is, however, pre-dominantly cotton-based with 70 per cent of the raw material consumed being cotton. It comprises of four major sectors, namely:

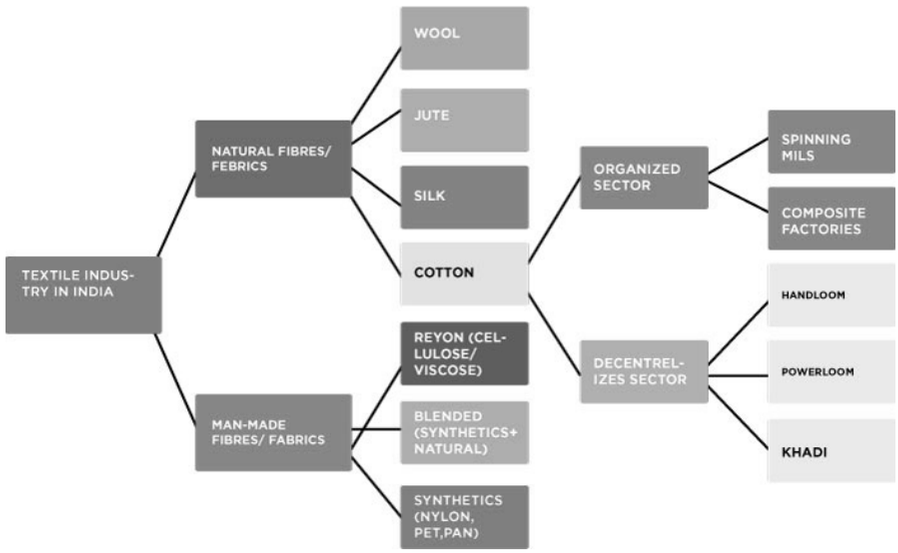
a. **The Mill Made**, also called the organised sector;

b. **The Handloom and Power Loom** sector both being classified as decentralised sectors;

c. **The Hosiery**; and

d. **The Garment** sector.

1.7 The composition of textile Industry in India and its structure could be understood from the following diagram:



2. HOSIERY INDUSTRY

Hosiery industry refers to the manufacture of garments made out of cotton, woollen or man-made yarn. The word 'hosiery' is derived from the word 'hose' appearing in hose top. (Hose top is a cylindrical garment worn on the leg below the knee and above the ankle.) Hosiery items manufactured in India are pullovers, cardigans, under-garments, woollen vests, trousers, mufflers, hose tops, stockings, shirts, sport wears, jackets, scarves, skirts, frocks, tops, baby blankets, bloomers, night suits, etc.

3. TEXTILE CENTRES

As per a report published in 2013 by the India Brand Equity Foundation, India is the world's second largest producer of textile and garments. Although the textile Industry has a Pan-India presence, Ludhiana in Punjab and Tirupur in Tamilnadu are the most prominent amongst the textile centres of India. Other centres are Bombay, Kolkata, Delhi, Surat, Ahmedabad, Jetpur, Saharanpur, Kanpur, Varanasi, Jaipur and Indore. The cotton hosiery industry is mostly concentrated in Ludhiana, Tirupur, Kolkata, Kanpur, Varanasi and around Delhi. The woollen hosiery Industry is thriving in Ludhiana and synthetic hosiery industries are concentrated in Bombay and Delhi, whereas in Jetpur, a small town in Saurashtra region of Gujarat, a majority of the units cater to the Cotton Saree Printing, having supply base to a variety of consumers in India and also from African subcontinent for printed cloth named as "khanga" and "kitange". A brief description of the two most prominent centres, Ludhiana and Tirupur, are given below:

3.1 Ludhiana Textile Centre: Ludhiana is the main centre for production of hosiery items in India and is also known as the 'Manchester of India'. The hosiery industry was established at Ludhiana in the early 20th century with the setting up of a socks manufacturing unit in 1902–03. Ludhiana which was a very small town, received significant migration from Pakistan after partition. People here started the knitting industry by using flat machines. Presently, there are about 14000 hosiery units in the city and it is the major town for small scale industrial units in Punjab and also the largest town of Punjab for industrial activities.

3.1.1 Ludhiana has full-fledged infrastructure for a successful industrial hub. About four or five lakh labour has migrated to Ludhiana from States outside the Punjab particularly from Bihar, Jharkhand and Uttar Pradesh. The estimated value of hosiery production in the year 2016 was Rs. 15000 crore. The direct export of hosiery goods from Ludhiana is estimated at about 30% of the production. About 4 lakh persons are directly or indirectly employed in the hosiery industry at Ludhiana alone.

3.2 Tirupur Textile Centre: Tirupur is a small town in Coimbatore district of Tamil Nadu. Traditionally, Tirupur is famous for its cotton market and cotton ginning factories. Though cotton trading and ginning operations have shrunk, Tirupur is still a very popular market for un-ginned cotton. The origin of hosiery industry in Tirupur may be traced back to the early 1930s. It is believed that the first hosiery factory with hand operated machines was setup in 1935. For more than 30 years, the hosiery industry in Tirupur was producing mainly grey and bleached *banians* (vests). In the late sixties, the industry slowly diversified towards manufacture of other inner garments. In the seventies, export of small quantities of *banians* and other inner garments were made from Tirupur. In the early eighties, export of knitwear, mainly basic T-shirts, were made in small quantities. Export of other items of knitwear gained momentum from 1985 onwards. In the late eighties, knitwear industry diversified very quickly and took up manufacture and export of knitwear. Besides knitwear, now knitted fabrics are also exported from Tirupur.

4. KNITWEAR SECTOR

4.1 Indian knitting industry has emerged as a premier supplier of value added items earning high foreign exchange. This industry has adapted itself to suit to the changing market conditions globally. Fashion designers from all over the world find Indian fabrics the perfect complement to their style. Knitwear sector in India grabs major chunk of its share in the country's textile exports. Exports of knitwear items from India have made strides and occupied 50% share of its total readymade garments exports. Indian knitwear is now being sold to almost every country in the world.

4.2 In simple terms, knitting refers to manufacturing of fabric with the help of needles. Before knitting started, the fabric was manufactured by weaving. The fabric thus manufactured was called woven fabric. The popularity of knitting has increased tremendously in recent years because of the increased versatility of the technique, the adaptability of many new man-made fibres, and because of the growth in demand for wrinkle free, stretchable, snug-fitting fabrics, particularly in the greatly expanding areas of sportswear and other casual garments.

4.3 Because of its looped structure, the knitted garments have the following advantages over the woven garments:

a. Price of a knitted garment is lesser than that of a woven garment, since yarn to fabric conversion is simpler and faster.

b. Knitted garments are more comfortable than woven garments because of their flexibility and stretch ability.

c. Knitted garments are more suitable for leisure and sports activities.

d. Knitted garments are light weight, soft touch and have excellent wrinkle resistance.

e. Knitwear can also be piece knitted like sweaters and socks thus eliminating cutting and sewing.

Because of these advantages, the usage of knitted fabrics ranges from hosiery, underwear, sweaters, slacks, suits, coats to rugs and other home-furnishings. At present, the knitting Industry meets an estimated 45% of the clothing needs in developed countries like USA, Europe and Japan.

4.4 Knitting consists of constructing a fabric on needles by inter-looping one or more yarns. It may be done by hand or machine. The basis of a knitted fabric is the loop or stitch by setting up a loop on a needle and drawing a strand through it to make a second loop. A chain of loops, each drawn through the other forms a knitted fabric.

4.5 The construction of knitted fabric is evaluated by the number of stitches or loops. When the interlocking loops run lengthwise, each row is called a wale. When the loop runs across the fabric each row is called a course. The quality of the needle effects the quality of the fabric. If the thickness of the loop varies from needle to needle the stitches vary in width. If all other parameters remain constant the fabric with more wales in it will be more rigid and stable in width, but a fabric with more courses in it will be more rigid and stable in length.

5. CLASSIFICATION OF KNITTED FABRICS

There are two broad categories of knitted fabrics.

a. Weft knit fabrics, where one continuous yarn forms courses across the fabric, and

b. Warp knit fabrics, where a series of yarns form wales in the lengthwise direction of the fabric.

5.1 Weft Knitting: There are three stitches in weft knitting-Plain knit stitch, Purl stitch, and Rib stitch which are discussed below.

5.2 The Plain Knit Stitch is a basic knit. This basic knit can be produced in flat knit or in tubular (circular) form. The flat knit is also called the jersey stitch. The knitting is done with a row of latch or bearded needles arranged in linear position on a cylinder. All the needles are evenly spaced side by side and are moved by cams, which act on the needle butts. The spacing of the needles is referred to as the gauge or cut. It usually refers to the number of needles per 1 ½ inch e.g. if a machine has 8 needles per inch the gauge of that machine would be 12. In cases where needles are adjustable, gauge refers to the number of needles per inch. The plain knit is made by needles intermeshing, loops drawn to one side of the fabric. Although there is a technical face and technical back to the plain knit, either side may be used as the face. The plain knit produces a relatively lightweight fabric compared to the thicker fabrics produced by the other stitches. It has high rate of production and is inexpensive. It is useful for variation in designs by pattern devices. These variations include stripes, multi-coloured patterns, textured surfaces produced by raised designs and pile effects. Horizontal stripes can be knitted by using different coloured yarns/ textured yarns on different feeders or by setting certain feeds to knit a looser stitch. Multi-coloured designs called *Intartia* can also be created through the use of highly specialized single bed machines.

5.3 The Purl Stitch is also called the links-and-links stitch. It is made on flat bed or circular machines by using needles that have hooks on both ends, to alternately draw loops to the front of the fabric in one course and to the back in the next course. The fabric looks the same on both the sides and resembles the back of the plain knit. It is often used in children's wear.

5.4 The Rib Stitch fabrics have alternating rows of purl and plain stitches so that the front and back of the fabric look alike. In a rib machine, one set of needles pulls the loops to the front and the other set pulls the loops to the back of the fabric. Each set of needles alternately draws loops in its own direction, depending on the width of the rib desired. Ribs have excellent width wise elasticity and are often used in underwears, socks, wristbands of sleeves and waist bands of garments.

5.5 Warp Knitting: In warp knitting, each needle loops its own thread. The needles produce parallel rows of loops simultaneously that are interlocked in a zigzag pattern. The stitches on the face of the fabric appear vertically at an angle and the stitches on the back appear horizontally. The warp knits are very popular and are appreciated for their smoothness, possible sheerness, wrinkle and shrink resistance, strength and abrasion resistance. Products ranging from hairnets to rugs may be manufactured by warp-knitting depending upon the machine and the technique employed. There are many types of warp knitting machines but those mainly used are Tricot and Raschel machines.

6. MACHINERY USED

6.1 Normally, three types of machines are used in hosiery knitting. These are round knitting machines, flat knitting machine and circular knitting machines. The size of the machine is known by its gauge. The gauge refers to the total number of needles in 1 inch. The higher the gauge of the machine, the finer the cloth it manufactures.

6.2 The round knitting machines are circular in shape and are used to manufacture socks and gloves. These machines may be hand operated or power operated. The socks and gloves manufactured by hand operated machines are

of coarse quality whereas the power operated machine manufactures finer quality socks and gloves.

6.3 The flat knitting machines are flat and square in shape because of which they are called flat knitting machines. The flat knitting machines may be either hand operated or power operated. The hand operated flat knitting machine is of 4 gauge to 14 gauge whereas the power operated flat knitting machine is of 8 gauge to 14 gauge. These machines are used for manufacturing sweaters, cardigans etc. Flat machine may also be computerized to get a particular design.

6.4 The circular knitting machine is one in which the yarn is fed through 'yarn feeders. The bed of the machine moves whereas the feeders and cams move to assist in the knitting process. These machines knit cloth in tubular form. This machine is used to knit various yarns like cotton, acrylic, polyester, nylon and their blends.

6.5 In the last decade, the machinery used in the hosiery and knitwear has undergone a sea change. Since the industry is highly labour intensive, locally manufactured and fabricated machinery and equipment suited to the capabilities of the lesser educated workforce are being used by the industry in almost all the operations involved in the manufacturing of low-end hosiery products right from the dyeing of yarn to stitching and packaging. However, more recently, the units that have diversified their manufacturing activities from the low-end products to high value-added fashion garments, have added the computerized/ motorized flat bed/ circular knitting machines, jacquard machines, modern stitching machines like flat, chain and lock stitch machine, computerized embroidery heads alongwith other gadgets and equipments. Similarly, ancillary supporting units like dyeing and finishing houses have also updated themselves with the latest version of machinery and equipment in soft flow dyeing, high pressure fabric dyeing and microprocessor-controlled piece dyeing, pole drying equipment, tubular calendering and stentering machines, colour matching and colour fastness testing equipment, etc. These machines, though quite expensive, have increased the production many times and have also substantially reduced wastage and rejections.

7. RAW MATERIALS

7.1 The basic raw materials used for the manufacture of hosiery products could be put under following four categories:

a. **Animal Fibre:** Animal fibre is the first among them. These fibres include sheep wool, angora wool, lamb's wool, mohair, etc. These yarns are supplied by spinning mills located at Ludhiana and Amritsar. Some of these mills supply dyed woollen yarn wound on cones. Others supply grey yarn in the form of hanks that is separately dyed in dyeing houses. Some yarns like Cashmere yarn and Pashmina yarn and also yarns of finer quality and some blended yarns are imported. Woollen yarns of various counts, mainly 2/ 32, 2/ 48, 3/ 11, 1/ 28 and 1/ 22 counts, are used for manufacturing.

b. **Seeds Fibre:** The second type of raw materials is seeds fibre like cotton. The cotton yarn is obtained from various spinning mills located in Punjab, Gujarat and other parts of the country. The spinning mills supply grey or dyed cotton yarn of different counts wound on cones. The main counts used in the manufacture of cotton knitwear are 10s, 20s, 24s, 30s, 34s and 40s.

c. **Man-Made Fibres:** The third category of raw materials are man-made fibres. These are polyester, nylon, viscose, acrylic,

etc. In this category polyester, nylon and acrylic are the yarns mainly used for the manufacture of knitwear either in pure form or in blended form. This yarn is manufactured by various large-scale units.

d. Blended Yarn: The fourth category is blended yarn. The synthetic fibres are also blended with animal as well as cellulose fibres to give them strength and durability. The main blends available in the market are polyester-cotton, polyester-viscose, wool-acrylic in different blends. Apart from the blending of the synthetic fibres, artificial silk is also blended either with wool or cotton to prepare yarn for manufacturing high fashion knitwear.

7.2 In addition to the above, certain other materials like buttons, zips, fasteners, sewing threads, embroidery threads, lining materials, tapes, laces, labels, size stickers and pipings are also used in the production of knitwear.

8. YARN COUNT

8.1 There is a fixed relationship between the weight of the original quantity of fiber and the length of the yarn produced from that raw material. This relationship indicates the thickness of the yarn and is designated by a number called the yarn count. The measurement of this relationship differs in cotton yarn and woollen yarn. In the case of cotton yarn, if one pound of fiber is drawn to make 840 yards of yarn, the resultant thickness represents 1 count. If the yarn is drawn out further, so that one pound makes twice 840 yards, the resultant count will be 2. If one pound of fiber is drawn out to make 32 times 840 yards i.e. about 15 Kms long yarn, the resultant count will be 32 or 32s i.e. 32 single. If two yarns of 32 count are twisted around each other, the result will be 2/ 32 and so on. The purpose of twisting around two yarns is to make the yarn stronger.

8.2 In the case of woollen yarn, if one pound of yarn is drawn to make yarn of 560 yards length, the resultant thickness of the yarn will represent 1 count. If the yarn of 1 count is further drawn out to make yarn of 32 times 560 yards i.e. about 10 Km, the yarn produced will have count of 1/ 32. In the case of man-made fibres, the thickness is measured in terms of deniers. If one gm of fibre is drawn to a length of 9000 meters, the resultant thickness of the yarn will represent 1 denier. If one gm of fibre is drawn to 100 meters yarn, the yarn would be of 90 deniers and so on. Therefore, in the case of woollen yarn and the cotton yarn, the higher the count of the yarn, the finer the yarn will be. However, in case of man-made fibres, the lower the denier of the fibre, the finer the yarn will be.

9. MANUFACTURING PROCESSES IN WOOLLEN HOSIERY

9.1 The basic raw material used in woollen hosiery is woollen yarn, which is obtained from greasy wool, mainly imported from Australia, New Zealand and South Africa. There are no restrictions on the import of wool. Any person having Exporter/ Importer Code Number from RBI can import wool. India produces about 45 million kg wool annually. However, it is not fit for apparel production because of its poor quality. It is mainly used in blankets and carpets.

9.2 The greasy wool is first of all scoured, carded and combed in a combing mill. There are 70 combing mills of various sizes in India mostly located in Ludhiana. Some combing mills are also located in places like Kolkata, Bhilwara, Mumbai and Vadodara. After combing, the greasy wool gets converted into wool top. The wool top is spun into yarn in a spinning mill. A multiplicity of processes is involved in combing and spinning but these are not discussed here in detail. Only a few units have composite manufacturing facilities of combing, spinning, dyeing and fabrication.

9.3 For the woollen industry, yarn constitutes the main raw material. The quality of yarn depends upon various factors like its composition, count, knots, twist per inch, breaking strength etc. Mainly yarn of 1/ 16, 2/ 20, 2/ 28, 2/ 32 count is used for manufacture of sweaters and cardigans. The yarn having 1/ 16, 1/ 28, 1/ 32, 1/ 42, 1/ 44, 1/ 48, 1/ 54, 1/ 56, 1/ 64, 2/ 30, 2/ 40, 2/ 42, 2/ 44, 2/ 48, 2/ 52, 2/ 64 count is used for manufacturing shawls. For blankets, the yarn having single count of 2 ½ to 10 is used. The fineness of the woollen yarn can also be known from its micron. Wool of 18 micron is considered as the finest. Wool having 18 to 24 microns is used in shawls whereas wool having 24 to 30 micron is used in hosiery.

9.4 Yarn is obtained by a garment manufacturer from a spinning mill. The yarn passes through many processes before the final garment is manufactured. First of all panels of the garment are knitted on flat knitting machines. Then they are checked and mended. The panels are then washed and steam-pressed after which the panels are cut according to the desired sizes. After doing embroidery work, if any, the panels are stitched together. Then the cups and necks are linked with the help of linking machines. After stitching buttons and fitting zips, the garment is washed or dry cleaned. Then the garment is inspected manually for any possible defect. After steam processing, the garment is ready for dispatch.

10. POTENTIAL ISSUES FOR INVESTIGATION

10.1 The Director General of Foreign Trade (DGFT) makes studies on input-output analysis in respect of various items from time to time after making detailed studies. The Ministry of Commerce publishes a 'Hand Book for Procedure' in which the details of input-output norms for various industries are given. This Hand Book is available in any office of the DGFT. While investigating the case of a manufacturer, the AO should go through this Hand Book to have an idea of the input-output norms stipulated by the DGFT for the products of the hosiery Industry. In case there is any substantial variation in consumption shown by the assessee and the consumption indicated in these norms, the AO should investigate the case thoroughly to find out the reasons for the same.

10.2 For the purpose of investigations, the units engaged in hosiery industry can be classified as follows:

a. Units engaged in exports.

b. Units catering to defence and other government requirements.

c. Units catering to the internal civil requirements.

There is no doubt about the fact that some units would deal in more than one type of goods, but broadly speaking, the units fall into one of the above three categories. Their *modus operandi* and the points of investigation involved in the above three categories are briefly discussed here under.

10.3 Manufacture for Exports

10.3.1 For export of knitwear, there is no need to obtain license for export as it does not fall in the list of restricted items. An exporter is primarily required to register himself with the concerned export promotion council (EPC) like the Wool & Woollens Export Promotion Council, and the Apparel Export Promotion Council. The concerned EPC allots a Code Number to its members. The Customs authorities will not allow the exporter to export goods unless the exporter is having Export Code Number. This number is required to be filled in the shipping bill and other documents. This number is also required to be mentioned in various foreign exchange declarations form like GR and PP forms. The Registration Cum Membership Certificate issued

by the concerned EPC helps the exporters to obtain incentives like cash assistance, duty draw back and replenishment licenses.

10.3.2 An export invoice is required to be prepared by the exporter both in terms of quantity and weight. Even the tare weight is mentioned therein. The AO, while examining the accounts, should work out the quantity of raw material embedded in the sale and tally it with the quantitative details of consumption, production etc. filed by the assessee.

10.3.3 The exports are to be made in bulk. While examining the accounts, the AO should look into the investment in purchases of different raw materials and payment of different expenses like wages, electricity, job charges etc. The source of generation of funds for making payment of these expenses by the assessee should be thoroughly examined. The assessee might have introduced its own unaccounted money in the guise of loans, advances, etc. for making payments for various expenses, more so easily in the cases of purchases of raw materials as those are often purchased from the farmers or brokers. Similarly, there could be a case of artificially inflating expenses by way of introducing bogus intermediaries for purchases of raw materials.

10.3.4 Further to the above, the following measures could be helpful to ascertain whether there is a case of suppression of income:

a. Work out the G.P rate in respect of export sales and domestic sales separately and try to find out the reasons, in case there is a substantial variation in the two G.P. rates.

b. Obtain bill-wise details of sales and various benefits received in order to see whether all the benefits have been reflected in the books of account or not.

c. Verify independently from the bankers of the exporters, the details of convertible foreign exchange credited to the exporter's account

d. Have a close look into the sale of visible wastage and make a proper analysis of the same. Scrap is generated in various manufacturing processes like cutting, and tailoring. It should be seen whether the assessee has shown any sale proceeds of the waste material.

e. Examine the accounts of the assessee to find out the fabrication and other expenses paid to its sister concerns. The charges paid by the assessee to its sister concerns may be lower than the market rates and this way, the assessee may have inflated its export income eligible for benefits and have suppressed the domestic income of the sister concerns.

f. The hosiery industry is a seasonal industry. Usually, the manufacturing activity is at its peak from the month of August to November. There is sharp fluctuation of labour employed in the peak season and in the off season. With the higher employment of labour in the peak season, the requirement for the machinery also goes up. The AO should see whether the machinery required for the peak season manufacturing is duly reflected in the account books or not.

g. Consumption of electricity may also be examined for the peak season and normal season so as to have an idea if there is any suppression of productions during the peak season.

h. Usually expenses such as payment to labour become very low during non-production/ very less production during non-peak seasons. Hence, the month-wise pattern of expenses may be examined

so as to ascertain whether there is a case of excessive and non-genuine claim of expenses during the months of non-peak period.

10.4 Supplies to Defence and Other Government Departments

10.4.1 Earlier all the purchases made by the defence forces were centralized with the Director General of Supplies and Disposals. However, to avoid delay in making procurements, the three wings of the Defence-the army, the navy and the air force-have been authorized to make purchases from the market. The purchases by the Army are made through the Director General of Ordinance Services whereas the Naval Head Quarters and the Air Force Head Quarters make purchases for Navy and Air Force respectively. Although, the Army has also its own factories to produce hosiery goods, it purchases various hosiery items from the market also.

10.4.2 For making purchases, the concerned wing of the Defence floats tenders. The tenders include such information as the quantity, price, duration of the contract etc. Besides, the manufacturer is required to supply the goods as per specifications stipulated by the concerned department. These include such details as the weight and size of the product, the details of yarn used. These departments lift the supplies after getting the goods inspected through various sources like the laboratory of the Textile Committee and Quality Marketing Centre. Mostly, yarn made out of pure wool or blended with nylon or nylon and viscose is used for defence supplies.

10.4.3 The manufacturers of defence goods use circular knitting machine, or flat knitting machines. Hand-operated round knitting machines are used for manufacturing socks and the power operated circular knitting machines are used for manufacturing vests. The hand-operated flat knitting machines are used for manufacturing jerseys.

10.4.4 Most of the units manufacturing hosiery goods for defence forces do not maintain quantitative details. They usually do not maintain any consumption or production records. Even if they maintain such records, they deny to be maintaining such details. In such a situation, an important point for investigation is the gross profit rate shown by the assessee. The gross profit rate shown in a particular year should be compared with the rates shown in the past and the rates shown by similar manufacturers. If the rate of gross profit shown by the assessee is lower, efforts should be made to find out the reasons for the same.

10.4.5 The AO should obtain copies of all the contracts executed by the assessee during the year. As discussed earlier, the contract orders give the details of raw materials to be used in the production of a particular item. The gross weight of the final product and the weight of the raw material to be used is specified in these documents. Therefore, the consumption of yarn required for manufacture of various items supplied by the assessee can be worked out.

10.4.6 The disclosed consumption of yarn can be checked from the figures of opening stock, purchases and closing stock shown in the books of account. In case, the consumption shown by the assessee is on the higher side, the reasons for it may be investigated. It is possible that the assessee may have inflated the purchases in the books. Besides, the consumption of other materials like buttons and zips should be looked into. The wastage shown by the assessee at various stages like knitting, cutting, tailoring may also be examined. The nature of the penalties, if any, levied on the assessee for breach of warranty should be ascertained and examined from tax angle.

10.5 Units Catering to Other Domestic Requirements

10.5.1 Apart from the issues relating to suppression of production, inflation of expenses etc. discussed previously in these cases, wastage is another item that should engage the AO's attention. He should enquire into the extent of wastage generated at different stages of production. The extent of wastage depends on the item being manufactured and the level of technology. It would be worthwhile to visit the factory premises of the assessee to have an idea of various processes involved in manufacturing. Nowadays, the manufacturers are using sophisticated computerized knitting machines. These machines are efficient. They generate very low wastage. The assessee might be claiming wastage on the basis of wastage shown in earlier years.

10.5.2 The AO should also compare the GP rate shown in a particular year with that shown in the earlier years. He should also compare the GP rate shown by the assessee with that shown by other persons in the same trade. In case there is significant variation, the reasons may be investigated. The assessee might have suppressed production or debited bogus expenses in the books.

10.5.3 The AO may also verify the genuineness of some of the purchases. However, the AO should carefully select the purchases in respect of which investigation is to be made. He may examine the purchases made by the assessee in the month of March. Any suspicious looking purchase bill should be investigated. The AO may also investigate the purchases made by the assessee ostensibly against credit but the payment in respect of which has been made subsequently through cash on various dates. Further, the purchases made during the year the in respect of which payment has not been made at all during the year, may also be picked up for investigation. The assessee might have introduced bogus purchase bills in the name of non-existing parties.

10.5.4 The purchases made by the assessee in the month of March or at the fag end of the season should be examined to see that these are either accounted for in production or in closing stock. The valuation of closing stock should be checked to ensure that the stock is valued properly keeping in view the purchase rates of the last purchase bills. Usually, the production in the woollen hosiery units continues up to the month of November or December. The purchases of needles made in the last part of the manufacturing season should be verified to ensure that the unconsumed needles are duly shown in the closing stock. Further, the AO should verify whether the material sent by the assessee for combing, spinning, dyeing, fabrication during the year but not received back till 31st March has been duly shown in the closing stock. The copies of the stock statements given by the assessee to the bank during the year for availing cash credit (hypothecation) facilities should be called for directly from the bank. The stock hypothecated to the bank may be more than the stock appearing in the assessee's books indicating unaccounted investment made in stock.

10.5.5 Most of the hosiery manufacturers make payments to the workers on piece-rate basis to optimize their production. However, in the books of accounts, they show the payments to the workers on monthly lump sum basis. The thumb impressions and the signatures of the workers appearing in the wages register/ muster roll may be examined. These signatures and thumb impressions may be similar as, usually, these registers are prepared afterwards. In case of such a situation, the possibility of invoking the provisions contained in Section 145 may be examined. In case the assessee has got any particular work done on piece-rate basis, the total quantity of the production may be worked

out on the basis of the charges paid for the work during the year. The figure of production thus arrived at may be checked with the number of pieces accounted for in the sale and the closing stock.

10.5.6 In the hosiery trade, most of the spinners make substantial cash sale of yarn. The cash sales of yarn made by the spinners are undoubtedly the unaccounted purchases of the hosiery manufacturers. To unearth such purchases, the possibility of conducting surveys under Section 133A during the peak season (August to November) may be examined.

10.5.7 The proceeds of the hosiery products sold outside the books of accounts are generally received through bank drafts. These drafts are not likely to be crossed or made account payee. They are generally purchased in favour of fictitious individuals for amounts below Rs. 20000/-. Till these drafts are encashed, they are transferred from one party to another merely through delivery. Ultimately, these drafts reach the commission agents/ brokers who make payments of these drafts by deducting brokerage. The brokers get these drafts credited in their bank accounts or some *benami* accounts. Such unaccounted sales may not possibly be detected through the normal enquiry process. To unearth such unaccounted sales, surveys under Section 133A may be necessary.

10.5.8 The AO may also collect information from the GST Department about the cases of tax evasion detected by them so as to verify whether there could be a case of tax evasion from income-tax perspective.

CHAPTER

6

Woollen Mills

1. INTRODUCTION

1.1 Wool is the animal fibre forming the protective covering or fleece, of sheep or of other hairy mammals, such as goats and camels. The woollen industry mostly uses wool obtained from sheep. Wool is a versatile fabric and is composed of a protein called 'keratin'. Wool is characterized by waviness with up to 12 waves per centimetre in fine fibres and 2 or less in coarser fibres. It also has scales on its surface which traps air and provides insulation from heat and cold. For obtaining raw wool, shearing of sheep is done from time to time. Different parts of the sheep's body provide different quality of wool. The wool from the shoulders and the sides of the sheep is considered superior and is called 'first fleece'. The first wool sheared from a six to eight months old lamb is also called 'lamb's wool' and it is of very fine quality. The wool from the head, chest, belly and shanks of a sheep is not very fine. Sometimes pelts of slaughtered sheep are also treated to loosen the fibre, yielding an inferior type called 'pulled wool'. Australia, China, USA, New Zealand, Argentina, South Africa, Uruguay, Kazakhstan etc. are the main wool producing countries in the world while India leads in the production of the coarser wool, also known as carpet wool.

1.2 India has the 3rd largest sheep population in the world, having 65.07 million sheep, producing 43.50 million kg of raw wool in 2017–18. However, the average annual yield per sheep in India is only 0.9 Kg. as against the world average of 2.4 Kg. Of the total Indian wool production, about 85% is carpet grade wool, 5% apparel grade and remaining 10% coarse grade wool for making rough blankets etc. A small quantity of specialty fibre is obtained from Pashmina goats and Angora rabbits also. Since the domestic produce of wool is not adequate, the Indian woollen industry is dependent on imported raw material. The woollen industry in the country is broadly divided & scattered between the organized and decentralized sectors. The organized sector consists of Composite mills; Combing units; Worsted and Non-Worsted spinning units; Knitwear and Woven Garments units; and Machine-Made Carpets manufacturing units. The un-organised sector consists of Hosiery and knitting; Power-looms; Hand-knotted carpets, Druggets, Namadahs units and other independent Dyeing, Process houses as well as the woollen handloom sector.

In India, wool industry is concentrated in Punjab, Haryana, Rajasthan, Uttar Pradesh, Maharashtra and Gujarat. Punjab alone accounts for about 35 per cent of wool production units, followed by Maharashtra and Rajasthan.

1.3 India exports various woollen products like tops, yarn, fabrics, ready-made garments and carpets. Carpet enjoys the maximum share of total exports. The aggregate export of woollen items from wool tops to finished products like textiles, clothing, blankets and carpets is currently estimated around app. Rs. 11484 Crores in FY 2017–18.

2. INDUSTRY STATISTICS

a. The major wool producing States in the country are:

Table 1

(Qty. in' 000 kg.)

S. No.	States	Wool Production 2017–18
1	Rajasthan	13924.19
2	Jammu & Kashmir	7411
3	Karnataka	4392
4	Telangana	4800
5	Gujarat	2267
6	Himachal Pradesh	1500
7	Maharashtra	1418
8	Uttarakhand	558
9	Uttar Pradesh	1404
10	Andhra Pradesh	793

Source: Animal Husbandry Deptt., Ministry of Agri.

b. In 2017–18 India imported raw wool from the following wool producing countries:

Table 2

S. No.	Country	Qty. in Tonnes
1	Australia	14079.488
2	China	10513.462
3	New Zealand	9157.914
4	Saudi Arab	4918.388
5	Pakistan	4690.367
6	Syria	4501.574

Source: DGCI&S, Calcutta

c. The details of year-wise, quantity-wise and value-wise import of raw wool are as under:

Table 3

Year	Qty. (in Million Kgs.)	Value (Rs. in Crores)
2010–11	94.77	1434.65
2011–12	76.29	1876.87
2012–13	77.16	1801.90
2013–14	89.60	1967.72
2014–15	96.53	2125.74
2015–16	97.83	2016.12
2016–17	87.15	1894.26
2017–18	79.95	1884.59

Source: DGCI&S, Calcutta

d. The item-wise Statement of Indian Woollen Exports are as under:

Table 4

(Rs. Crores)

Year	Woollen Yarn, Fabrics, Made ups	Ready Made Garments	Carpet (Excluding Silk) Handmade	Total
2013–14	684.70	1888.60	6255.83	8829.21
2014–15	1234.61	1901.76	8301.56	11437.90
2015–16	1284.91	1724.86	9421.75	12431.52
2016–17	1180.24	1443.26	9956.63	12580.13
2017–18	1197.86	1089.97	9196.99	11484.82

Source: DGCI&S, Kolkata

e. The main destination of Indian exports of Woollen Yarn, Fabrics, Made Ups are as under:

Table 5

S. No.	Country	Value in Crores (2017–18)
1	Italy	261.86
2	United Kingdom	193.90
3	Japan	122.69
4	Korea RP	106.83
5	USA	48.50
6	Bangladesh	36.39

Source: DGCI&S, Calcutta

f. The main destination of Indian exports of Carpets, excluding Silk, is as below:

Table 6

S. No.	Country	Value in Crores (2017–18)
1	USA	4716.61
2	Germany	905.50
3	Australia	362.62
4	U.A.E.	183.28
5	Netherland	179.79
6	Italy	164.46
7	France	153.88

Source: DGCI&S, Calcutta

g. In 2017–18 the major destination of Indian exports of Readymade Garments Wool was as under:

Table 7

S. No.	Country	Value in Crores
1	USA	233.81
2	United Arab	105.59
3	United Kingdom	103.74
4	Tanzania	95.58
5	France	64.44
6	Canada	49.35
7	Germany	46.38

Source: DGCI&S, Calcutta

3. GRADING OF WOOL

3.1 The grading of wool is very crucial determinant of its price and demand. It is not to be confused with other classifications of wool. The Finer (smaller diameter) wools are associated with more expensive, lighter weight fabrics, while the coarser-fibered wools (larger diameter) are used in bulkier sweaters, blankets, and carpets. There are three systems of wool grading which are commonly used:

a. The American or Blood system;

b. The English or Spinning Count system; and

c. The Micron system.

3.1.1 The American Blood Grade System was developed in the early 1800s and originally represented the amount of fine-wool Merino genetics (Spanish origin) present in the native coarse-wool sheep. The American Blood Grade System now no longer refers to breeding background but now represents a broad description of fiber diameter. The English system of grading wool uses a measurement called the "spinning count" and is based on the number of "hanks" of yarn which could be spun from one pound of clean wool on the equipment available at the time the system was developed. Finer wools have more individual fibers per unit of weight. Consequently, more hanks of yarn can be spun from fine wool than coarse wool (one hank is 560 yards). Increased emphasis on an exact and highly descriptive method of describing wool grade has produced a measuring system in which individual fibers are accurately measured in terms of microns. Nowadays the standard method of measuring wool fibres is by a microprojection technique in which short longitudinal sections of the fibres are projected onto a screen at 500-fold magnification. As the wool gets coarser, it becomes necessary to measure significantly more fibres to ensure a high degree of accuracy. Wool that grades in

the 62s spinning count requires about 3,000 fibre measurements, while 50s spinning count wool requires taking more than 6,000 fibre measurements to ensure acceptable accuracy. All the three systems above are measures of average fibre diameter only and they can be used interchangeably as shown in the table below, but the micron system is the system used internationally and is preferred by wool buyers and manufacturers:

Table 8

Type of Wool	American or Blood Grade	English or Spinning Count Grade	Microns (Average Fibre Diameter)
Fine	Fine	Finer than 80s	Under 17.70
Fine	Fine	80s	17.70 - 19.14
Fine	Fine	70s	19.15 - 20.59
Fine	Fine	64s	20.60 - 22.04
Medium	1/ 2 Blood	62s	22.05 - 23.49
Medium	1/ 2 Blood	60s	23.50 - 24.94
Medium	3/ 8 Blood	58s	24.95 - 26.39
Medium	3/ 8 Blood	56s	26.40 - 27.84
Medium	1/ 4 Blood	54s	27.85 - 29.29
Medium	1/ 4 Blood	50s	29.30 - 30.99
Coarse	Low 1/ 4 Blood	48s	31.00 - 32.69
Coarse	Low 1/ 4 Blood	46s	32.70 - 34.39
Coarse	Common	44s	34.40 - 36.19
Very Coarse	Braid	40s	36.20 - 38.09
Very Coarse	Braid	36s	38.10 - 40.20
Very Coarse	Braid	Coarser than 36s	Over 40.20

3.2 The following method of grading of Indian wool is also followed in India:

Table 9

Sl. No.	Type of Wool	Mean Fibre Diameter (in Microns)
1.	North India superior clothing white	≤ 30
2.	North India clothing white	30 - 42
3.	North India rug white	43 - 46
4.	North India carpet type	≥ 46
5.	South India blanket type	43 - 46
6.	South India tannery type	≥ 46

4. CLASSIFICATION OF WOOL

4.1 Wool is also classified in terms of its other characteristics e.g. sorting fleeces into various lines according to fineness, length, strength, yield, color, and style. Fine wools are about 4 to 7.5 centimetres long and the extremely coarse fibres may be as much as 30 centimetres in length. The soft and fine wool fibres are suitable for garments and clothing whereas coarse fibres are used for making carpets. In India wool is also classed as per the season of clipping, the breed of sheep, the colour of wool and the 'scoured yield' per centage. The percentage yield of clean scoured wool (greasy wool minus its grease, wax, sweat, dirt and plant material) is the product which gets to be processed by the manufacturer.

As much of the greasy weight consists of these impurities, the proportion must be known so that the price per kilogram in the greasy wool that will correspond with the clean-scoured cost can be fixed. The higher the yield, or the greater the percentage of pure wool in the consignment, the higher the greasy value will be.

4.2 Woollen yarn also gets classified in three categories on account of its length and fineness as under:

a. **Woollen Yarn:** Woollen yarn is manufactured from shorter stapled wool. The woollen yarn is quite loosely spun with little twist and the fibres are also not very parallel. The woollen fabrics have a soft fuzzy surface. Tweeds, Shetland, Cashmere are the examples of woollen fabrics. The woollen fabrics made from this kind of yarn are warmer than the worsted fabrics but they are not as durable though woollen yarn is generally less expensive than the worsted yarn.

b. **Worsted Yarn:** Worsted yarn is manufactured from longer stapled wool. In worsted yarn, the fibres are laid as parallel as possible and the yarn is also smooth with relatively high twist. Gabardine, Whipcord Serge, Worsted Cheviot, Tropical Worsted and Bed Ford Cord are examples of worsted fabrics.

c. **Shoddy Yarn:** To meet the increasing demand of wool and in view of the limited supply of new wool, worsted fibres have to be recovered from old clothing, rags and other such waste in wool manufacturing. This wool is known as 'shoddy wool'. The shoddy wool sector provides cheaper clothes. Besides, the hardier shoddy fibres obtained from good original stock blended with new wool from lamb etc. add durability to the soft new wool.

5. MANUFACTURING PROCESS

After shearing and grading/ sorting, the manufacturing process of woollen yarn can be divided into following stages:

a. **Scouring:** The greasy wool contains the natural oils of sheep, dust, and other impurities that are picked up by the sheep or from the bushes and plants where they had been grazing. Before the greasy wool is washed, it is passed through a machine called the wool duster or wool opener. In this machine, thick knots in the raw wool are opened. This machine consists of cylindrical drums that have pins on their outer surface. When the raw wool rolls alongwith the drums, the pins separate the thick knots from the wool. The knots and other undesirable materials such as dust fall down through an opening and the remaining wool is delivered out from where it is collected. To further remove the impurities, the first process involved is the scouring or washing. The scouring machine consists of chambers which are equipped with automatic rakes, which stir the wool. The first few chambers of the machine use water, detergents and a mild solution of soda ash to remove the grease and dust from the raw wool. A temperature of 70 degree Celsius is maintained in these chambers using steam from a boiler. The last chamber contains clean water, in which wool coming out of the earlier chambers is washed. It also has rollers to squeeze out the water. After scouring, the wool is passed through the dryer for drying. However, it is not dried fully and a 12 to 16 per cent moisture is left in the wool to condition it for subsequent handling. The chemical process used to remove vegetable matter from wool is referred to as Carbonising.

b. **Carding or Combing:** After drying, the wool is passed through various carding

machines for carding or combing. These are two related techniques for preparing wool fibres for making either woollen or worsted threads respectively. In the case of woollen yarn, the main objective of carding is to individualize the fibre by passing the wool fibre through various rollers covered with fine wire teeth. The wool fibres are brushed and individualized by wires. Some dirt and foreign matter are also removed at this stage. Since the woollen yarn should be somewhat rough and fuzzy, it is not necessary to make the fibre too parallel to each other. One sliver of wool is placed diagonally overlapping another sliver by use of an oscillating device which provides a fuzzy surface to the yarn. After this process, the woollen slivers go directly to the spinning operations. However, in the case of worsted yarn, the essential purpose of the combing is to make the fibre as parallel as possible. Combing is a technique whereby wool fibres are passed through a series of straight, metal teeth in order to lay the fibres parallel to one another. The fibres are then placed together in a long line ('combed sliver'), which is used to spin a smooth, even thread. In this process, long fibres are separated from shorter ones ('noils') and tangles are removed. At the same time, practically all remaining foreign matter is removed from the fibres. In general, combed fibres are cleaner, finer, stronger and more lustrous than carded ones. Most of the combing units in the country are located at Ludhiana and Amritsar. However, some combing units are also located in the states of Haryana, Maharashtra, Rajasthan, West Bengal, etc. The Wool combing capacity of the units is around 30 million kg per year. After scouring and carding/ combing, the wool obtained is referred to as 'wool top'..

c. Spinning: In the spinning process, the 'wool top' is spun into yarn. The wool top slivers obtained are first of all passed through gill boxes and rubbing frames. These machines have several pairs of rollers, each revolving at a progressively faster speed. This action pulls the staple lengthwise and makes the sliver thinner. The sliver is also given a little twist in this process. The drawing out and twisting continues till the fibre is about the diameter of a pencil lead. After these processes, the fibre is placed in the spinning frames where it passes through a series of rollers running at successively higher speeds. The fibre is ultimately drawn out to the yarn of the desired size. After passing through spinning frames, the yarn goes to the winders for winding on cones. Now the yarn is ready to be used by the fabric manufacturers.

d. Weaving: Next, the wool yarn is woven into fabric. Wool manufacturers use two basic weaves: the plain weave and the twill. Woollen yarns are made into fabric using a plain weave (rarely a twill), which produces a fabric of a somewhat looser weave and a soft surface (due to napping) with little or no luster. The napping often conceals flaws in construction. The Worsted yarns can create fine fabrics with exquisite patterns using a twill weave. The result is a more tightly woven, smooth fabric.

e. Finishing: After weaving, both worsteds and Woollens undergo a series of finishing procedures including: fulling (immersing the fabric in water to make the fibers interlock); crabbing (permanently setting the interlock); decating (shrink-proofing); and, occasionally, dyeing. Although wool fibers can be dyed before the carding process, dyeing can also be done after the wool has been woven into fabric.

6. IMPORTANCE OF WOOL TESTING

6.1 Since 1930, the International Wool Textile Organisation (IWTO) is the recognized global authority for standards in the wool textile industry and for protecting the interests of the parties in the global wool trade. Since international trading of wool requires clear specifications of the quantity and quality of the wool and all parties to the trade need to be assured that these specifications have been achieved, the IWTO Test Certificates are essential to the wool trade. IWTO issues licenses to various test houses to issue IWTO certificates. The Test Houses licensed by IWTO are further accredited by their national standardization bodies and the relevant tests are carried out in strict compliance with IWTO test methods and regulations. Through this process, buyers and sellers can use IWTO certificates with confidence. In addition, IWTO Certificates are backed by the IWTO Arbitration Rules that outline the rights and responsibilities of all concerned, including those of the testing authority.

6.2 The Test Houses and similar Authorities are the ones which issue a certificate to the supplier regarding the probable results expected from a particular lot of the wool consignment. The major wool testing authorities in the world are Australian Wool Testing Authority Ltd, Australia; SGS Wool Testing Services, New Zealand and Wool Testing Bureau, South Africa. The requisite certificate is issued by them on the basis of samples taken from the lot of the wool being dispatched by the supplier. The certificate gives such details as the wool base, mean fibre diameter, vegetable matter base and clean weight of the consignment. Clean weight represents the quantity of wool top, noils, shoddy and burrs likely to be obtained from the consignment of the greasy wool after the combing process. This also includes the amount of moisture contained in the wool. The wool base is the weight of dry wool (excluding moisture) likely to be contained in the consignment. The mean fibre diameter represents the average thickness of the fibre in microns (micro-metres). The vegetable matter base is the amount of vegetable matter present in the greasy wool. After combing, the comber also issues similar certificate to the importer on the basis of actual combing results. Usually, there is no variation in the actual results and the anticipated results shown in the certificate issued by concerned wool testing authority. In India the Central Wool Development Board (CWDB), Jodhpur has its wool testing laboratories at various locations. The Indian Institute of Carpet Technology also has a laboratory at Bhadohi, Uttar Pradesh for the Carpet and Textile Industry. The Central Sheep and Wool Research Institute, Tonk, Rajasthan also has testing laboratories. Wool testing is also done by the Textile Testing Lab of the Wool Research Association, Thane.

7. POSSIBLE LINES OF INVESTIGATION FOR ASSESSING OFFICERS

7.1 The assessing officer should keep in mind that except for carpet wool, most of other raw wool used in India is imported. A wool trader imports the wool and supplies it to the wool agent who further sells it to the spinner. The rest of the value-chain for wool consisting of the stages of dyeing, weaving, fabric processing and end-product manufacturing remains the same as that of cotton. The only minor difference is that wool fibre is only ring spun not rotor spun.

7.2 The carpet industry in India mainly produces three types of carpets-tufted, knotted and woven carpets-all of which are hand-woven. Carpets are predominantly produced from wool though other materials such as cotton, polyester and viscose are also used in various blends. The value chain of the carpet industry is unique in the sense that it centres around carpet manufacturers who typically have the in-house facility for finishing and dyeing as well. They

can be involved in any part of the value chain, directly or indirectly. They buy the wool fibre from agents who in turn procure it either from domestic wool growers or through imports. The manufacturers subsequently get the wool spun and dyed on job work basis. A similar process is followed for non-woollen yarn which is bought directly from their manufacturers or from their yarn agents. The yarn thus produced is sent by the carpet manufacturers through contractors who act as master weavers. They get the yarn woven from the weavers on job work basis. The woven carpet is finished in the in-house facility of the carpet manufacturers or through job work as applicable. The finished product thus produced is either sold to buying agents, domestic buyers or exported. The buying agents further sell the finished goods directly in the domestic market or export it.

7.3 The first step involved in the investigation of accounts in the case of a woollen mill is the verification of the consumption-yield ratio. The yield should be seen at two stages-at the stage of conversion of wool top from greasy wool, and at the stage of the conversion of wool top into yarn. As far as conversion from greasy wool to wool top is concerned, there is no fixed ratio of yield since it depends upon the quality of the greasy wool. Usually, the wastage at this stage varies between 30 to 40 per cent although it may go up to 70 per cent if the quality of the wool is inferior.

7.4 Before dispatch, most of the consignments of greasy wool sent by foreign suppliers are tested by the wool testing authority of the concerned country. All these authorities issue a certificate called 'IWTO Combined Certificate'. This certificate contains details of the mean staple length, mean diameter of the fibre, dry weight of the fibre free from all impurities (also called wool base) and the vegetable matters base. The IWTO Schlumberger Dry (Top & Noil Yield) is a commercial yield which predicts the amount of Top and Noil that can be combed from a greasy lot. The Indian combers also issues similar certificate to the importer after actual combing. Usually, the results found on actual combing are marginally better than the results shown in the certificate issued by the wool testing authority concerned. In case there is substantial variation between the results, the reasons should be enquired into. It is likely that cheaper and inferior quality wool might have been blended with the imported wool. The assessing officer may go through the correspondence between the comber and the importer to find out the reasons for the variation. The correspondence of the importer with the supplier may also be gone through as, usually, the importer lodges the claim for compensation with the foreign supplier, through its indenting agent, in case there is any substantial variation between the expected results as shown in the certificate issued by the Wool Testing Authority and the actual results. In case the assessee has not lodged any claim for compensation, the genuineness of the claim of low recovery of wool top from the greasy wool shown by the assessee becomes all the more doubtful.

7.5 For verifying the yield of wool top from the scoured wool or the yield of yarn from wool top, it will be worthwhile to compare the results shown by the assessee with the input-output norms for various industries prescribed by the Director General of Foreign Trade. The assessing officer should go through these norms. In case, there is any substantial variation between the yield shown by the assessee and the input-output norms prescribed by the DGFT, the assessing officer should thoroughly investigate the case for detecting possible bogus purchases, inflated expenses or suppressed sales. The Input-Output Table, Commodity by Commodity Matrix, 2007–08 prepared by the CSO, MOSPI, Government of India (2013) indicates the following per centages of inputs in woollen textile products:

Table 10

(In Per cent)

Structure of Inputs	Woollen Textiles	Carpet Weaving
Textile inputs	45.1	42.2
Non-textile inputs (goods)	19.5	19.9
Non-textile inputs (services)	33.9	36.7
Total Non-textile inputs	53.4	56.6
Non-textile inputs (not shown)	1.4	1.2
Total	100	100

7.5.1 Details of relative shares of inputs from the textile sector to produce textile sector outputs are shown in Table XI. Textile products are produced out of textile inputs in different mixes and blends and at different stages of value added.

Table 11

(In Per cent)

Product	Woollen Textiles	Carpet Weaving
Jute	0.01	3.74
Cotton	10.74	0.40
Khadi, cotton textiles (handlooms)	0.35	1.08
Cotton textiles	2.58	4.16
Woollen textiles	17.85	7.69
Silk textiles	0.20	0.46
Art silk, synthetic fibre textiles	6.10	10.73
Jute, Hemp, mesta textiles	1.11	3.26
Carpet weaving	0.25	0.01
Readymade garments	4.29	2.30
Miscellaneous textile products	1.43	6.61
Synthetic fibres, resin	0.21	1.73
Total	45.12	42.17

7.5.2 Similar breakup is available for the relative share of Non-textile inputs (Goods) and Non-Textile inputs (Services).

7.6 The woollen industry has to pay Goods and Services Tax on wool top and on wool yarn. These rates would need to be checked as the GST Council changes the rates from time to time. The combing mills, spinning & weaving mills have to maintain certain statutory registers. The Register of Goods Produced contain the day to day details of quantity manufactured and cleared from the factory. Similarly, the other mandatory registers like the Input Tax Credit Availed, Output Tax Liability, Output Tax Paid, Input Tax Credit Availed, Sales Register, Stock Register and Purchase Register can be examined to find and correlate the amount of GST paid and total quantity of wool top or yarn manufactured. The register also gives information regarding the raw material used in manufacture of various goods. The registers also give such information as the opening balance, quantity of raw material purchased, visible wastage, invisible wastage, closing balance of raw material, etc.

7.7 The assessing officer should prepare a month-wise consumption-yield ratio chart on the basis of the information available in the registers mentioned earlier. In case the yield shown by the assessee for some months is substantially lower than the yield shown in other months, the assessing officer should investigate the reasons for the same. The assessee might have introduced bogus purchase bills or might have shown excess wastage in the months in which the yield shown is significantly lower. It will also be worthwhile to compare the figures of stock appearing at the end of each month with the stock shown by the assessee in the stock statements given to the bank for the corresponding months. This exercise may reveal any unaccounted stock hypothecated by the assessee to the bank.

7.8 The greasy wool contains natural oils of sheep. After scouring, the oils are removed from

the wool. In the case of scouring and combing units, it should be kept in mind that the cleaning the fleece removes 'wool grease'. This is a fatty substance which is purified to make Lanolin (yolk), a by-product which is extensively used in pharmaceutical and cosmetic industries. Most of the combing plants have installed machinery for extraction of grease from the oils removed from the greasy wool. The assessing officer should find out whether such grease has been accounted for in the books of accounts by the comber or not.

7.9 The valuation of closing stock also needs to be checked carefully. Sometimes, the customs duty on the raw material is not included in the value of closing stock resulting in undervaluation of closing stock. The duty paid by the assessee on imported raw material constitutes an important element in the total cost of the goods and, accordingly, requires to be added to the value of imported raw material. Further the assessing officer should also verify whether the material sent by the assessee for combing or dyeing during the year but not received back till 31st March, has been included in the closing stock or not.

7.10 The assessing officer should also check whether the Customs/ GST authorities have imposed any penalty on the assessee. Sometimes, the assessee debits the penalty to the purchase account without showing the same as penalty. The assessee may even debit the penalty to the capital account of the partners in a Firm so that the fact of the imposition of the penalty does not come to the notice of the Revenue. It would be worthwhile to go through the vouchers relating to the custom clearing agents as they make the payment on account of custom duty or the penalty to the Customs on behalf of the assessee. Penalties cannot be allowed as deduction. Besides, the penalties may reveal the modus operandi adopted by the assessee for earning unaccounted profits. The assessee might be importing fine quality wool under the garb of rags or inferior quality wool and making unaccounted investment on purchases outside the books of account.

7.11 The assessing officers should be aware of the various Government initiatives taken in this sector from time to time. The Government Departments are a good source of information for the assessing officers. The 'Central Wool Development Board' (CWDB), Jodhpur, under the administrative control of Ministry of Textiles has been formed to develop the domestic wool textiles industry by undertaking various support programme. It also has a 'Market Information Network' which publishes fortnightly raw wool and woollen yarn prices in respect of various woollen articles. It also gives information about the arrival and sale of raw wool in various mandies in the country. There is also the 'Wool & Woollen Export Promotion Council' which promotes woollen exports.

CHAPTER 7

Woollen Carpet Industry

1. INTRODUCTION

1.1 The important carpet producing centre in India are Mirzapur, Bhadohi, Gopiganj, Khamaria and Agra in Uttar Pradesh, Srinagar in Jammu and Kashmir; Amritsar in Punjab; Panipat in Haryana; Jaipur and Bikaner in Rajasthan; Gwalior in Madhya Pradesh, Eluru and Warangal in Andhra Pradesh; Madras and Walajapet in Tamil Nadu and Obra in Bihar. The popular qualities of Bhadohi and Mirzapur in Uttar Pradesh vary from ordinary to medium fine; finer varieties are from Agra, Jaipur, Amritsar and superior varieties come from the Kashmir. The rough Berber and Shaggy carpets are in complementary colours while the Hamadan variety is brightly coloured and heavy. The exquisite mulberry silk carpets are light, silky, glossy and woven in multiplies shades.

1.2 Indian carpets are available in different sizes and lengths of pile, which may be as low as 1/ 5 of an inch as in Kashmir carpets or as high as 7/ 8 of an inch as in the Indo-berber variety. Amongst Persian carpets the different qualities are generally known as: 3/ 28, 5/ 40, 7/ 52, 8/ 56, 9/ 45, 9/ 60, 10/ 62, 10½/ 48, 11/ 55, 12/ 60, 14/ 70, 16/ 80, 15/ 75. Knots per sq. inch can be obtained by multiplying both the figures and dividing it by 4. For example: 3/ 28 means (3x28)/ 4 or 21 knots per sq. inch.

1.3 The warp of a carpet is always of cotton or jute except in a few special carpets like Bokhara in which woollen warp is used. When wool is used for warp, the carpet clings to the floor and is considered superior. The quality of the carpet depends upon the knots per sq. inch, which varies from 6 to 1000. Generally, it is 20 to 400. The Indian handmade woollen carpets are usually made with following tools:

a. A loop made of wood.

b. Chhura: It is a curved steel knife for cutting the thread after a knot is tied.

c. Panja: It is a heavy comb of iron with wooden handle for beating the waft and the pile tufts.

d. Kainchi: or scissors for cutting pile level.

1.4 Generally, for hand-woven woollen carpets, machine made yarn is used but hand-spun yarn is regarded as superior to machine spun yarn. Spring clipped wool is considered superior to

autumn clipped wool. The former is stronger and gives better results. There is also a difference in sheep's and lamb's wool.

1.5 An average weaver can make about 12000 knots in a day. The minimum knots expected of a weaver are 15 per minute or 900 per hour. In other words lowest quality Persian carpet can be woven by a weaver at the rate of about 4 sq. ft. per day, while superior quality carpets like 12/ 60 and onwards, can be woven at the rate of ½ sq. ft. per weaver per day.

1.6 The above average knotting also varies with different types of knots. The knots are of five types namely, Persian, Turkish, Tufted, Tibetan or Nepali. The last three knots are on four strings of warp instead of two, and carpets made with these knot are considered only half as good as the carpet with the other knots.

2. MANUFACTURING PROCESS

2.1 The process of carpet manufacturing can be broadly divided into three stages:

a. Manufacturing of woollen yarn from raw wool;

b. Dyeing of woollen yarn in different colours as per requirement; and

c. Carpet-weaving and process of finishing of carpet.

The first stage, namely, manufacturing of woollen yarn is generally carried out separately except in some cases, where all the three stages are carried out by the same covers. Traditionally dyeing used to be done by the manufacturing concerns themselves but these days separate dyeing units are established by many independent houses.

2.2 Raw Materials: The raw materials for the woollen carpet industry comprises of imported raw wool, indigenous wool, both indigenous and imported man-made fibres, and imported woollen rags. The subject of wastage, shortages and losses at various processing stages in the carpet industry considerably impact the profitability of such concerns.

2.3 Shortage/ Gains in Transit: As per standards fixed by International Wool Testing Authority (IWTA), the imported wool is sold on conditioned basis. For each article of wool, certain standard regains are fixed in respect of imported wool. In the case of the carpet wool, the conditioned weight is about 16 to 17 per cent. Every lot is accompanied by a certificate from a Conditioning House in which the moisture content is mentioned. This is called 'regain per centage'. It would therefore, be desirable for the AO to go through the original vouchers of imported wool and ascertain the narration about the conditioning and the weight for which the price is charged. IWTA has fixed norms of conditioning loss or regains to avoid disputes amongst the parties making transactions across the world. When there is a higher content of moisture in the atmosphere, the weight of wool increases as it absorbs moisture of even 25 per cent or more. However, in the case of Indian wool, the original vouchers for purchase do not indicate the moisture content. The moisture content in the wool is normally the same as in the atmosphere. The loss in weight on account of driage/ loss in transit may vary from 2 to 5 per cent.

2.4 Willowing: The first operation in the case of woollen carpet yarn is 'willowing' or 'zaffery'. During this, the wool is passed through a willowing machine, which removes dust, thorns etc. from the wool. The shortage in willowing varies from 5 to 8 per cent, depending upon the quality of wool. The waste material recovered is not capable of reuse and is sold as manure. The assessees not having willowing machines, engage labour for beating the wool to separate the dust, thorns etc. This operation is called 'zaffery'. The loss in 'zaffery' may vary from 5 to 6 per cent.

2.5 Blending and Oiling: After willowing has been completed, the process of 'blending' and 'oiling' is performed. Different grades of wool or other fibres are blended with the willowed wool. For manufacture of woollen yarn, different colours and qualities of wool fibre or the reprocessed yarn are blended in the desired combination. This is done to reduce the cost of yarn as also to create a mix of colours or special effects. It also helps in the spinning process. The Mills maintain a Blending Register that contains particulars of recovery, wastage, and wastes delivered to the wool godown including soft, hard, shoddy, sweepings and invisible loss, etc. These particulars are also available along with the oil (Mahua or castor oil) and the chemicals used in the 'woollen blend card'-a card maintained in the Blending Section to reconcile the various results, recoveries and shortages. This card is submitted to the mill's office on completion of the blending process. This information if checked up, at random, will give a clear picture of the working of the mill.

2.6 Carding and Spinning: In this process, the yarn is sent for carding, spinning and dyeing. Carding is done by passing wool through the machines where its locks are separated, and the rearranged fibres come out. All out efforts are made to open, separate and straighten the individual fibres of the stock. The fibres are rearranged in different directions, crossing and re-crossing as much as possible. Short/ broken fibres can be accepted. In this process there is also some invisible waste which should be compared with assessee's previous records, as also with similar cases. This occurs when some fibres go into the air and fly away. Visible loss is on account of miscellaneous impurities, still left over which are removed at this stage. For verifying these losses, the AO can call for the records maintained in the carding section.

2.7 Carding and spinning are complementary processes and are done together. The bobbins are brought into a machine called 'Mule', on which the yarn is spun. The wastage/ shortage during carding and spinning process varies between 6 to 10 per cent. The usable waste recovered from carding and spinning operations is as high as 60 per cent of the total wastage in this operation. Out of the wastage in carding and spinning operations, 40 to 50 per cent is reusable visible waste that can be reused; and 10 to 20 per cent is unusable visible waste that is sold to shoddy manufactures.

2.8 Reeling, Scouring, and Dyeing Processes: The yarn is unfolded from the bobbins and rewound into 'hanks'. This is known as 'reeling' and is done mostly by hand, for which reeling wages are paid according to quantity reeled. The production by each reeler is noted in the Register for Reeling production. The 'count' of yarn is a term used to express the fineness of yarn, i.e., the number of hanks of yarn which weigh one kg. The yarn after being unfolded from bobbins and rewound into hanks, is either sold in market or sent for scouring and dyeing. The object of 'scouring' is to remove the oil added before spinning and other impurities in the wool. The loss in scouring may vary from 12 to 15 per cent and that there is no recovery of visible waste. A vigilant AO should carefully scrutinize the cases of assessees who are not themselves performing all the operations involved in spinning of yarn and manufacturing of carpets, and have instead formed different sister concerns for carrying on different operations.

2.8.1 Dyeing Process: In the dyeing section, there are several dyeing machines of different sizes in which different colours and proportionate weights of yarn are put together. Expenses on colours and chemicals should be compared with other comparable cases and the assessees earlier record. Normally wastage or shortage in dyeing should range between 2 to 3 per cent depending upon the wool and yarn's quality, and, whether the process is of machine-dyeing or hand dyeing. The dyeing section, maintains a receipt book that contains information on shortages/ wastage. If the claim under this head is excessive, the

receipt book can be examined. If dyeing is got done through independent dye houses, the loss in dyeing and the details of yarn dyed in terms of weight, colour and dyeing charges can be cross-verified from the books of the dye houses.

2.9 Weaving Process

2.9.1 After all these processes, the yarn is ready for weaving-either by hand if the carpet is to be hand-knotted and hand tufted or by machines. In the first case, the weavers can be either assessee's own full-time employees; or working full time on contract basis; or outside weavers running their independent weaving business. Generally, hand weaving is got done through weavers working full time on contract basis for the assessee. In Persian carpets, the weaving charges vary from Rs. 200 per sq. yard to 5500/- per sq. yard.

2.9.2 The processed yarn is given to weavers. Weaving, finishing, cutting, clipping etc. is done in the weaving section, after which the carpet is ready according to the design and specification given to weavers. It is extremely difficult to have an idea of wastage in this Section, as it depends upon the expertise of the weaver, his moods, experience and the quality of supervision etc.

2.9.3 Hand weaving involves following steps:

a. Issue of raw material (woollen yarn, cotton yarn) to weavers.

b. Supply of design/ map with the materials.

c. Description of quality, size to be manufactured.

The material is issued through 'purja' that serves as gate pass also. In some cases, separate gate passes are issued. From these 'purjas' the issue register is prepared with following columns:

Description	Design	Size	Quality

2.9.4 The weavers take the raw material and weaves the carpet as per the design given to them on loom-either alone or with some other weavers depending upon the size of carpets. The loss in weaving process is negligible. When the weavers complete weaving, they return the carpet to the manufacturing houses. At that time entries of manufactured carpet are made by the assessee in the Bazar Register.

2.9.5 Generally, the carpet manufacturer employs the same weaver for weaving carpet, year after year. These weavers may be employed as regular employees or on contract basis. The percentage by a particular weaver can be cross-checked with the percentage wastage by the same weaver on earlier occasions for a carpet of the same quality. As the weavers become more experienced, the wastage should come down. The weaver can also be summoned to verify the claim of shortage.

2.9.6 Most of the big mills maintain detailed information about the receipt of yarn, daily production of carpets therefrom, quality, colour of yarn, weight of carpets etc. on cards maintained in the weaving section.

2.10 Finishing: The various finishing processes such as cutting, grossing, washing, back burring, clipping (embossing in embossed carpets), binding, stretching etc. are generally done in the premises of the manufacturing houses. However, in recent years, a practice of getting the carpets washed by different units is becoming popular.

2.11 The processes of manufacturing the Tufted and Tibetan carpets are almost similar, with the following variations:

a. Tufted: Separate looms made of pipe are used. The tufting is made on cloth and then put on the loom. After finishing tufting latex, jute and the thick cloth are used to support the tufted carpet. The weaving of this carpet generally takes less time compared to Persian carpets.

b. Tibetan: Separate looms made of girders are used. The weaving process is very simple and require less time compared to Persian carpets. No knots can be found in these carpets andweaving is generally on contract basis/ job work basis and weaving charges are 200–250 per sq. yard.

2.12 Netting: After the carpet has been made, 'netting' is done with cotton net or jute net to give support to the yarn and to make a base for the carpet. Cotton net is used as base for hand-tufted carpets and jute net is used for machine made ones. Liquid rubber is also used to even out the backside of carpet and to give it support and to properly hold the yarn. This special quality rubber called 'latex' is issued on licenses issued by the Rubber Board. Usually, 5 to 6 liters of liquid rubber is consumed for every square yard of carpet area.

3. MANUFACTURING LOSSES AND SHORTAGES

3.1 In opening and reel-making stages, the wastage could be 1 to 1.5 per cent depending upon whether this is done by machine or by hand. The hooking loss can be between 2.5 to 5 per cent. Further, in cutting, finishing and clipping, the process shortage may be between 4–5 per cent. The clipping wastage is sold to 'kabaris' or used as shoddy. The overall shortages/ loss in various processes can be between 25 to 35 per cent. In some cases, losses of upto 40 per cent have been claimed. These require probe from primary books and cards/ registers discussed above.

3.2 The normal wastage at different stages can be summarized as under:

Willowing/ zaffery	= 5 to 8%
Blending	= 1 to 2%
Oiling	= Nil (in fact, oiling adds to weight of wool)
Carding, spinning & reeling	= 6 to 10%
Scouring	= 12 to 15%
Dyeing	= 2 to 3%

Wastage in excess of the above require detailed enquiries by the Assessing Officer.

4. COST ACCOUNTING AND PROFITABILITY

4.1 Apart from various shortage and wastage discussed above, the manufacturing/ production expenses may also require investigation. The normal thickness (i.e. height of the yarn) of carpets is 12–18 mm for handmade carpets and 6–8 mm for machine made carpets. The consumption of yarn per sq. meter depends upon the thickness of yarn. This varies from 1.5 to 2.00 kg per sq. meter from handmade carpets and is around 1 kg per sq. meter for machine made carpets. Therefore, the proportion between the total yarn consumed and the total carpet area should be calculated with other similar cases. In a number of cases of carpets of normal thickness, the average consumption was found to be around 30 gms of yarn per square foot. The average cost per square foot of Persian carpet depends on the cost of yarn, the consumption of yarn per sq. meter and the weaving charges. Other carpets such as tufted etc. are cheaper and highly in demand.

4.2 The G.P. rates in these cases vary from 15–25 per cent due to the highly ambulatory nature of this industry. These per centages are after excluding the credit of cash entitlements, subsidies and incentives from the trading account, since the amounts of these incentives go on varying every year.

5. BANK LOANS

Advances are taken by the carpet manufacturer/ exporters in two stages. The first is the pre-shipment stage in which they have to hypothecate the stock to the bank. The second is the post-shipment stage of packing credit, where the exporting unit obtains the advance against the bill drawn on the foreign buyer.

6. INFLATION IN PURCHASES

6.1 Usually wool is purchased on contract basis. A 'contract book' is maintained showing the serial number of the contract, date of the contract, names and addresses of the parties, quality and quantity contracted, rates and period of delivery etc. A receipt register is also kept showing the details of wool received and weighed in the factor, showing the date of weighment, contract number, party's name, quality, rates etc. The weighed wool is given a lot number before being consigned to the godown. A 'lot book' is also maintained showing the lot number, quantity, quality, date of receipt, rates, supplier's name, weight, dates of issue and mixing. In suspected cases of tax evasion, it is necessary to obtain a full list of the wool purchases showing lot-wise details.

6.2 In one case, it was found that in the lot-wise statement a purchase of Rs. 1,50,000/- was shown together with the lot number but in the lot book there was no entry of that particular lot number. This suggested that no such lot had actually been purchased and Utilised. On enquiry, it emerged that this amount of Rs. 1,50,000/- was carriage expenses. But according to the contract, wool was to be delivered with freight fully paid at the assessee's factory premises. Ultimately, it turned out that the amount Rs. 1,50,000/- was a transfer entry by which a similar debit in the account of the managing agents was squared up. Thus a comparison of the terms of the contract and the entries in the lot book would enable the AO to identify fictitious or inflated items of purchases. In some cases, even the contracts were manipulated to show purchase rates higher than the rates at which they were actually contracted, thereby substantially inflating the value of the wool purchased. There are also instances where, although the average count of yarn spun is comparatively low, the average cost of wool consumed is disproportionately high. In such cases collusion between the assessee/ its representatives and the wool supplier may be suspected.

6.3 Fictitious Purchases: Where a mill shows abnormally low profits or losses as against good profits shown by similar others in the line, there may be reasons to suspect inflation in the rate and value of wool purchased or in quantity. Such quantitative inflation would be reflected in the low output of yarn or large invisible wastage. These low rates can be the starting point for further detailed investigation. In such cases, purchases that appear to be from dealers who have not much of a standing or who have not made supplies either before or after that purchase should be selected and cross-checked. Such an enquiry might reveal the bogus nature of the item particularly, when it is pursued as to its movement, storage, payment of godown rent etc.

6.4 Suspense Purchases: In some case, there is also the practice of suspense purchases. Under this system, the seller gives possession to the buyer but retains the right to fix the price on future date of his choice, after taking advance of about 50 to 60% of the current market price of the wool sold. If the price is not fixed by the seller before the end of the accounting year of the buyer, the purchaser takes the rate prevailing on the last day of the accounting year and debits the purchases account with corresponding credit to the seller. On the first day of next succeeding year the entries are reversed until the rate is finally fixed between the seller and the buyer. This system lends itself to evasion of tax as the assessee might make an entry showing that prices were fixed when the market was very high. But careful enquiry with the seller may show the rate at which he actually sold the wool. It is useful to refer to trade journals such as "Wool intelligence Bulletin" and "Wool and woollens of India".

These contain wool purchases rates from time to time.

7. INFLATED CLAIMS OF WASTAGE

The loss in weight on account of driage/ loss in transit may vary from 2 to 5 per cent. The AO can find out inflated claims of driage or loss in transit in the case of imported wool by referring to the original vouchers and ascertaining the percentage of moisture content. The loss in 'zaffery' may vary from 5 to 6 per cent. If an assessee is showing loss in both 'zaffery' and 'willowing', the AO must make a thorough probe.

8. INFLATION OF CHARGES

Inflation of charges, particularly scouring charges paid to other concerns, is a common malpractice. In one case, it was found that the assessee was carrying on the business of manufacture of carpets but was not manufacturing yarn itself. It would purchase raw wool from the market and give it to its sister concern after zaffery for spinning of yarn. The spun yarn was then given to another sister concern for dyeing. The dyed yarn was then to be used for manufacture of carpets. Neither the assessee nor the sister concern carrying on spinning of yarn had shown recovery of visible waste. Again, to inflate its expenses, the assessee had paid scouring charges to both the sister concerns. Ongoing through the past records, it was found that, in none of the earlier years, scouring charges were paid at two stages. During the year under consideration, the assessee had bumper profits and it adopted this tactics to reduce its income.

9. INFLATION IN STORES ACCOUNT

9.1 Usually, purchases of stores are debited to the stores account and periodical transfers are made to the stores consumption account, which ultimately appears in the manufacturing amount. The following tax evasion methods have been detected in some of the cases.

9.2 In one case, a mill advanced large amounts to sundry parties in one year. In the subsequent year, these advances were squared up by transferring the same to the stores account, for which stores bills were prepared to make it appear that the mill had purchased stores from these parties. Although receipts and issues of stores were shown in the stock register, there were no slips issued to the storekeeper for issue of these stores. Besides, the stores suppliers could not be traced out.

9.3 In another case, the stores account showed purchase usually ranging from Rs. 1000/- to Rs. 5000/- on various dates from various parties. In respect of five items however, the purchases in cash exceeded Rs. 15000/-. On investigation, it was found that the alleged suppliers had given bills showing the names and address of far off places. These bills also showed telegraphic code and telephone number etc. On enquiry, with the postal department it was found that there was no such telegraphic code or telephone number, nor was there any such dealer at the address given. Besides, no freight charges were claimed for the transport of the stores. The explanation was that the stores were brought by the agents of the suppliers when they visited the mill. There was no correspondence and the payments were made by bearer cheques although even in respect of cheaper items the payments had been made by crossed cheques. When the matter was further pursued, it was found that the bearer cheques were actually encashed over the Bank's counter by the mills' manager. When the manager was examined, he admitted that the money encashed had been paid to the managing partner and that he did not know the alleged suppliers.

9.4 Where the component of stores consumption in the cost of production is high, it would be

necessary to obtain comparative details of the quantity and value of certain selected item of stores consumed for different accounting year, as this will reveal the items in which there has been substantial increase and a further pursuit of purchases of such stores may result in the detection of inflation in those items.

9.5 Rate of purchase of stores may also be inflated in collusion with suppliers. Sometimes, the suppliers may be only benamis of the assessee or the concerns in which it is interested.

10. INFLATION OF WAGES

This is another area in which expenses can be easily inflated. In the case of permanent employees, a regular muster roll is kept under the Factories Act. The inflation is usually in the muster roll for temporary employees. In one case, a perusal of the muster roll for temporary employees showed that lump sum amounts were added at the end of the each week to the total of the temporary wages shown in the "Temporary wages register" and the whole amount was debited to the wages account of the mill. These lump sum amounts were actually withdrawn by the partners. In some cases, only thumb impressions of the so-called labourers were taken and their whereabouts or names were not available.

11. CAPITAL EXPENDITURE AS REPAIRS

Sometimes, capital expenses such as construction of a new shed or a wing etc. are claimed as revenue expenditure through this account. Besides, cash advances might be shown in one year in the name of some sundry parties and they would also be shown in sundry debtors balance. In the subsequent year, these advances are squared up by transferring the same to the repairs account on the basis of certain typed bills alleging that these persons carried out repairs to the building or roads in the mill premises. While expenses on looms can be capitalized for the purpose of depreciation as per rules, the reasonableness of the expenditure on other tools and consumable stores should be watched carefully. The life of the other tools is not so short and if excessive or unreasonable expenditure on tools and consumable stores is claimed, the AO must make a thorough probe.

12. PRODUCTION AND CONTROL OF GST AUTHORITIES

12.1 Under the GST Act, the woollen mills are obliged to maintain records of yarn production, detailed stock accounts, quantities removed from the factory, gate pass particulars, description of goods removed etc., in various prescribed registers. The mills maintain such records, and these can be quite useful for investigations. It is also useful to examine the Spinning Master's daily production report and compare it with the Spinning register, which records the production at the spinning point. The spinning production can then be compared with the reeling production which should normally be higher, as yarn gathers weight in the reeling process due to moisture content, but by the time the reeled yarn is bundled and baled, some of the moisture content is again lost. Therefore, the baling production is more or less equal to the spinning production.

12.2 In one case where search was conducted *u/s* 132, it was found that the yarn production was recorded in the stock register at a figure much less than the daily production report submitted by the spinning master. In fact, duplicate daily report statements were got prepared to support the entries in the stock register. The actual production so diverted was sold through the mill's retail depot to weavers and dealers in yarn. Therefore, in suspected cases of evasion, it is essential to gather stock and production details from the primary books of entry including original production reports.

13. SUPPRESSION OF SALES

13.1 Suppression of sales turnover is common in this line of business. In the case of a carpet manufacturer, some special arrangements were made for sales during specific periods which indicated a departure from the normal established procedures. It was found that it was selling its products to some firms on consignment basis. The assessee had agreed to bear the cost of freight, storage, godown and other allied charges, till the date of sale of the goods. Goods that could not be sold were returned to the assessee. These firms used to pledge the goods with the bank and dispatch the amounts to the assessee that would pay the interest on the amounts advanced. The commission paid along with other expenses as interest, godown charges, freight cartage, Octroi etc. worked out to be more than 20 per cent of the sale proceeds. Enquiries revealed that these dealers were getting favoured treatment. The arrangement of sale on consignment basis was found to be a method for diverting a part of profits to these dealers with whom the assessee had entered into collusive arrangement.

13.2 In cases of sale of carpets to tourists, often advances are received against the sale proceeds, but these do not find any mention in the regular receipts. A German national visited a carpet factory where she selected a carpet for 2800 dollars and paid advance of 800 dollars with an agreement that the remaining amount of 2000 dollars would be sent as soon as the carpet was dispatched to Germany. In the order-form, copy of which was supplied to the German national, the manufacturer mentioned the advance of 800 dollars. However, in the invoice that was dispatched along with other papers to the Clearing Agent the amount mentioned was 2000 dollars only. It so happened that the carpet was lost in transit and did not reach the destination. When the German national claimed damages from the insurance company, the insurance company offered 2000 dollars only i.e. the sum mentioned in the invoice. She lodged a complaint with the authorities after which the assessee's premises were raided. It was then found that the advance of 800 dollars was mentioned only in the order form and was not entered in the regular books. Therefore, while scrutinizing accounts, the order forms that are usually issued at the time of advances received from the customers or at the time of booking should also be thoroughly scrutinized.

13.3 Very often sale of wool waste is shown at a reduced rate. Such sale may be to persons who are dummies or benamidars of the assessee.

14. EXPORTS AND IMPORTS

14.1 The carpet industry in India is basically export-oriented and its local demand is limited. With an estimated 1,00,000 looms employing about five lakhs weavers, the industry has a fairly large production base in the country. Export Sales is an important area of investigation in suitable cases.

14.2 Non-repatriation/ non-realization of the export sale proceeds is a major issue. Often exporters enter in collusive arrangements, wherein the outstanding proceeds are partly realized and the balance proceeds are retained abroad. Simultaneously, these amounts are claimed as irrecoverable bad debts. The foreign exchange so accumulated is used for personal expenses on visits abroad.

14.3 Information relevant to income-tax assessments can also be gathered from the offices of Textile Committee of Inspection, Controllers of Imports and Exports and Regional Textile Commissioner functioning under the Commerce Ministry. The Textile Committee inspects the quality and quantity of the intended exports, and issues a certificate regarding the fitness of the goods for export on the basis of which Government allows incentives to the exporters. The Textile Commissioner's office has useful information regarding the quality of goods and raw material imported, license no. and the actual user of the goods, total production etc.,

Similar, information can also be obtained from the Regional Controllers of Imports and Exports.

14.4 The Indian woollen industry is heavily dependent on imported raw wool and wool tops. India buys raw wool mainly from Australia, New Zealand and Japan. The AO may, in suitable cases, verify whether the importer has properly Utilised the imported material for the purpose for which it was imported or the same was sold off in the black market at premium and has fabricated his production and sale accounts.

14.5 The AO should also ensure that all cash assistance whether due or received has been properly accounted for in the relevant year according to the system of accounting followed regularly by the assessee. It may be useful to collect full information regarding payment of cash assistance from the regional offices of the Controllers of Imports and Exports to find out if there is any discrepancy in accounting for such receipts in the respective accounts.

14.6 Import Entitlements: The object of Import Replenishment Scheme is to provide registered exporters import replenishment licenses, to import material required by them for manufacturing the product to be exported. The rate of the replenishment license against export is given in the import policy, which is normally announced in the month of April each year. Such REP licenses are also transferable, unless they are held by Import Houses and used for importing OGL items for actual users. The AO may verify the correctness of transactions relating to transfer of REP licenses at a particular rate of premium. Where the commodity to be imported against a REP license is a scarce one, the possibility of the transaction involving on-money cannot be wholly ruled out.

14.7 Cash Incentives etc.: It is also necessary to verify whether various cash incentives, subsidies and entitlements given to exporters are properly reflected in the books of accounts. These incentives are allowed to increase the export of carpets. The cash compensatory support in case of carpets is paid upto even 20 per cent on the FOB value.

15. SOURCES OF INFORMATION

Some of the main trade bodies and departments having technical data/ expertise on export trade are specified hereunder:

a. All India Handicrafts Board.
b. Wool and Woollen Export Promotion Council
c. Institute for Carpet Technology at Bhadohi (UP)
d. Regional Textile Commissioner
e. Textile Committee of Inspection
f. Chief Controller of Imports and Exports and its Regional Offices.
g. Reserve Bank of India (Foreign Exchange Department).
h. Directorate of Enforcement (Foreign Exchange)
i. Customs & Central Excise Department
j. All Indian Carpet Manufacturer's Association Bhadohi.

CHAPTER

8

Packaging Industry

1. OVERVIEW

1.1 India has the world's 5th largest Packaging Industry. Packaging Industry is also one of the fastest growing sectors in India, consistently displaying a growth rate of 15–20% per annum[1]. Additionally, India is fast emerging as a preferred hub for packaging industry since the cost of processing and packaging food in India could be up to 40% lower than in Europe which, combined with India's resources of skilled labour, make it an attractive venue for investment.

1.2 Packaging activity is umbilically connected to major industries like pharmaceuticals, food processing, FMCG, healthcare etc. India presently exports packaging materials like flattened cans, printed sheets, cork & caps, plastic film laminates, craft paper, paper board and packaging machinery to other countries. The imports into India include tinplate, coating and lining compounds and others.

1.3 The value of packaging consumption in India amounted to INR 81110 crores in 2012 which is projected to grow to INR 148860 crores in 2018[2]. As per Business Wire (a Berkshire Hathaway Company) Indian packaging industry was predicted to see notable growth over 2016–2021, growing at a Compound Annual Growth rate(CAGR) of 9.2% as compared to 6.2% during 2011–2016[3]. As per the same report Flexible Packaging is the leading packing type in the Indian packaging industry and will itself grow at a healthy CAGR of 8.9% during 2016–2021, with major contributions from the Food, Household Care, and Cosmetics & Toiletries industries. This growth is largely driven by its low cost and flexibility to suit multiple shapes and sizes, convenience (zip-locks, plastic closures), and low-carbon foot print on the environment as compared to Rigid Plastics. In addition, the increasing prominence of low-density flexible packs in high protein foods is expected to drive the growth in the future.

1.4 As per the FICCI-TSMG report[4] the packaging industry in India is expected to reach USD 73 billion by the fiscal year 2020. The report prepared by FICCI and Tata Strategic Management Group (TSMG) on plastic packaging industry declares that the Indian packaging industry, which is valued at over USD 32 billion in FY 15–16 after growing at a CAGR

of 16% in the last five years, offers employment to more than 10 lakh people across the country through 10,000 firms. The report also mentions that presently the Indian packaging industry constitutes 4% of the USD 700 billion worth global packaging industry. Presently the per capita packaging consumption in India is low at 4.3 kg, compared to developed countries like Germany and Taiwan where it is 42 kg and 19 kg respectively. Therefore, in the coming years, the Indian packaging industry is expected to grow at 18% per annum, wherein, flexible packaging is expected to grow at 25% per annum and rigid packaging to grow at 15% per annum. The overall packaging industry in India has a huge growth potential and is expected to reach USD 73 Billion in FY 20–21.

1.5 In common parlance, the term 'Packaging' connotes the wrapping material around a consumer good and which is used to indicate, hold and protect the product. However, such a simplistic notion has long been discarded. In the modern world of marketing, the consumer is the king and consumer satisfaction is the key. Packaging now forms a major part of advertisement and it also communicates the product information to the consumer. Further, the concepts of brand image, trade mark, pattern, design and other intellectual properties also tend to focus on Packaging to a large extent. Packaging has veritably attained the status of an 'Art' in its quest to lure the customers towards the particular product by playing upon their senses of sight, smell, and touch. The marketers now also use sound e.g. clicks or pops emanating from the packaging as well to push their products. Together with the product, its price, its promotion and its placement, the packaging determines the success of any product. It is essential to note that even if the average manufacturer may not have an idea about packaging but the sales team of the packaging industry ensures transmission of new concepts and technology.

2. TYPES OF PACKAGING

The packaging industry can be segregated in three broad categories, based on the nature of packaging, the type of materials used and the function or layers of packaging.

2.1 Based on Nature of Packaging

According to the nature of the material used the Packaging industry can be broadly classified as:

a. Rigid packaging

b. Flexible packaging

Rigid packaging would include glass, tin, aluminum sheets, wood, plastics and paper (corrugated boxes and carton board). Flexible packaging segment uses lightweight, durable and flexible materials like plastic films and aluminium foils. In the global packaging market, rigid plastic packaging gets an advantage over glass or metal packaging due to its weight and design flexibility. Rigid plastic packaging is mainly used in industries such as food and beverage, personal care, and home care. The metal packaging segment is also experiencing a drop in the demand due to shifting trends and consumer preferences.

2.2 Based on Materials Used for Packaging

Another categorisation can be based on the materials used for packaging as under:

a. Glass packaging;

b. Metal packaging;

c. Polymer packaging; and

d. Paper packaging.

2.3 Based on Function on Packaging

The packaging industry can also be classified, based on the function or layer:

a. Primary packaging;

b. Secondary packaging; and

c. Tertiary packaging.

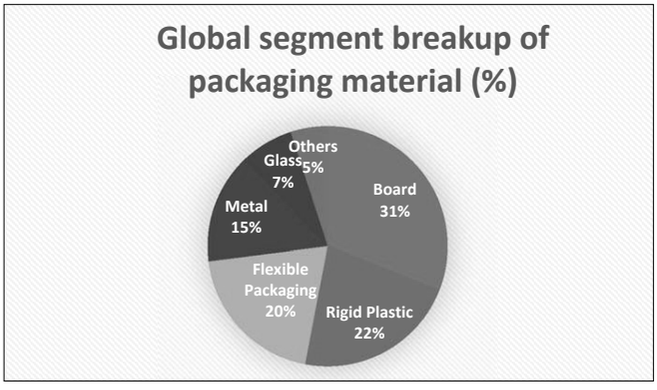
2.3.1 The Primary packaging is the one which comes into direct contact with the product and which does not react with the product. It is mostly used in packaging food products like ready-to-eat foods, beverages, snacks etc. where paper or aluminium foil is laminated or metalised for packaging purposes.

2.3.2 The Secondary packaging is the outer layer of primary packaging. Apart from protecting the products, it also acts as a mode of marketing and branding eg. carton board boxes etc.

2.3.3 The Tertiary packaging is used for bulk packaging. These are commonly used for storing and transporting products, such as industrial chemicals, consumer durables, fruits and vegetables etc. The examples of tertiary packaging are corrugated boxes, steel drums, HDPE barrels and containers etc.

3. BRIEF NOTE ABOUT SOME PACKAGING MATERIALS

3.1 The global pattern[5] of consumption of various packaging materials is displayed in the graphic below:



3.2 Corrugated Cardboard

The prices of corrugated sheet and converted boxes in India have generally remained low due to over-capacity, manual operations and low productivity. There are nearly 4000 corrugated board and sheet plants in the country, which are highly labour intensive. The scenario is under challenge on account of a flourishing organized retail segment and the consumption of corrugated packaging has begun to rise. More and more new automatic plants are being setup to meet the new demand for high precision boxes with attractive graphics and large integrated production capacities. The MNCs are also demanding corrugated boxes of international standards.

3.3 Plastics

Plastics are the most commonly used packaging material in India also. The common plastic resins used in packaging are LLDPE (Linear low-density Polyethylene), HDPE (High-density polyethylene), PP (Polypropylene), BOPP (Biaxially-Oriented Polypropylene), PET (Polyethylene terephthalate) etc. Most of the plastic packaging is manufactured using high precision machines. The brochures of plastic packaging machineries contain lots of information about their functions, consumption figures and output figures. The 'plastic packaging' is the foundation of the consumer culture due to its cost to performance ratio. As can be seen from the symbolic table below, Plastics are fast replacing traditionally used materials in many segments:

Product	Traditional Material	Current Trend
Milk/ Edible Oil	Glass/ Metal	3/ 5 Layer Film pouches
Toiletries (Soap/ Shampoos)	Paper/ Glass	Plastic Pouches/ Films
Cement/ Fertiliser etc	Jute	PP/ HDPE Woven Sack
Toothpaste	Metal	Lamitube

3.4 Laminated Tubes

These lamitubes, as they are now referred to, are multi-layered plastic tubes with a 'barrier layer' in between. The plastic layers are made of polymers and the barrier layer is usually a thin

metal foil. Such lamitubes are basically used for oral care products, pharmaceuticals and creams. Of late the metal foils have been replaced with Ethylene Vinyl Alcohol and these plastic laminate structures can be coloured. Some lamitubes also come in transparent plastic with Ultra Violet blockers, if required. A few players have also introduced laminated tubes using the recycled high-density polyethylene i.e. High-Density Polyethylene Post Consumer Resin (PCR HDPE) with organic polymers. In all such cases the supplier needs to invest in suitable printing technologies also. Presently the pharma sector and the home care products sector still depend on aluminum foil based lamitubes whereas the beauty and cosmetics industry has moved on to the plastic barrier laminates.

3.5 Others

Shrink Film Packaging: Is a fast-growing trend due to its multiple benefits besides costing nearly a third of corrugated boxes. *Woven sacks* have also emerged as a major Packaging material in cement, fertilisers, agri-produce etc replacing paper/ jute. The *Packaging peripherals* like crowns, corks and caps are also significant components. The newer packaging materials are in the field of aseptic packaging, retort packaging (a type of food packaging made from a laminate of flexible plastic and metal foils) and biodegradable packaging.

4. PACKAGING MANUFACTURING SUPPLIERS

4.1 India has domestic packaging machinery manufacturers and it also imports the same. The Indian imports of packaging equipment consist mainly of highly automated advanced machines and systems. The major equipment suppliers to the Indian market include Germany, Italy, Switzerland, and others including Taiwan and the U.S. While German companies are the lead suppliers of machinery for filling, closing, sealing and labeling bottles, cans and boxes, and wrapping and aseptic packaging machinery, the U.S. firms mainly export filtering/ purifying, wrapping, aseptic packaging, form-fill-sealing machines and extruders.

4.2 Currently, there are an estimated 20 major companies worldwide in the organized sector that manufacture packaging machinery. The major suppliers are Krone AG, Sidel Group, Bosch Packaging Technology, KHS GmbH etc. The Technology, price, delivery, and performance standards are critical factors that determine whether packaging equipment can be sold in the Indian market. Due to intense competition in the end-user market, the cost of equipment and low running cost remain one of the primary factors that influence the sale of the packaging equipment. Upgrading is another other extremely important factor in the buying decision of Indian end-users. After-sales service is also a key concern of buyers.

4.3 Some of the major domestic equipment manufacturers supplying the market are Flex Engineering Ltd., (Noida), ITW Signode India Ltd. (Hyderabad), Print Pack Machinery Ltd. (Faridabad), Eagle Manufacturing Co. (Mumbai), Larsen & Toubro for various type of packaging machinery; Acrofil India (New Delhi), S.P.M. Engineering (Bangalore), E.C. Packaging (Faridabad), specifically for filling and sealing machines; S.P UltraflexSystems (Mumbai) for flexible packaging machines; and Multi Pack Machines Pvt Ltd. (Hyderabad), and Primo Pack (Ahmedabad) for pouch packing machines. Many domestic firms have established joint ventures with foreign companies to produce a variety of packaging machinery.

5. PACKAGING MACHINES

There is a large variety in packaging machines and the main packaging manufacturing machines are of the following general types[6]:

a. Accumulating and collating machines
b. Blister packs, skin packs and vacuum packaging machines
c. Bottle caps equipment, over-capping, lidding, closing, seaming and sealing machines
d. Box, case and tray forming, packing, unpacking, closing and sealing machines
e. Cartoning machines
f. Cleaning, sterilizing, cooling and drying machines
g. Coding, printing, marking, stamping, and imprinting machines
h. Converting machines
i. Conveyor belts, accumulating and related machines
j. Feeding, orienting, placing and related machines
k. Filling machines: handling dry, powdered, solid, liquid, gas, or viscous products
l. Inspecting: visual, sound, metal detecting, etc.
m. Label dispenser
n. Orienting, unscrambling machines
o. Package filling and closing machines
p. Palletizing, depalletizing, unit load assembly
q. Product identification: labeling, marking, etc.
r. Sealing machines: heat sealer
s. Slitting machines
t. Weighing machines: check weigher, multi-headweigher
u. Wrapping machines: stretch wrapping, shrink wrap, banding
v. Form, fill and seal machines
w. Other specialty machinery: slitters, perforating, laser cutters, parts attachment, etc.

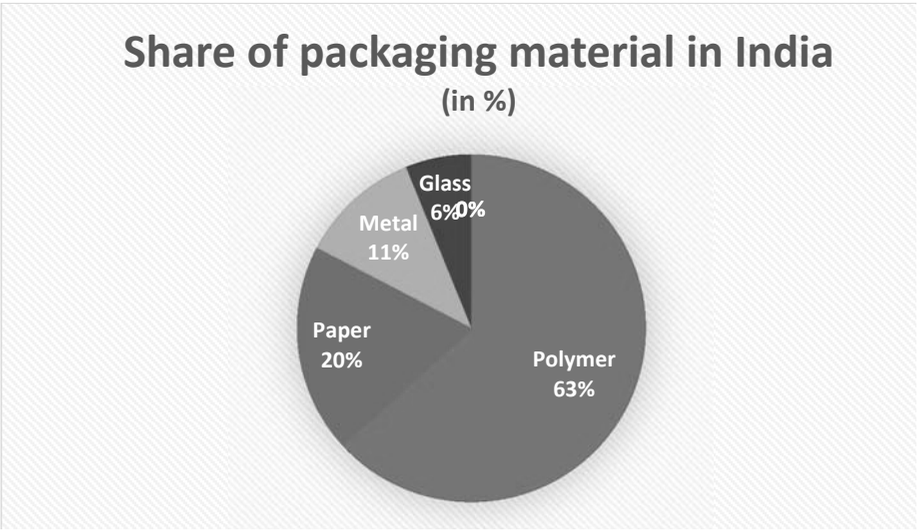
6. MARKET SCENARIO

6.1 In 2015, Asia-Pacific Region had the largest market share among all regions, and is expected to retain its dominant position in near future as well. This is mainly because packaging film manufacturers are shifting their manufacturing facilities to countries such as India and China to reduce their operational costs.

6.2 The Indian Packaging industry, regarded as a commodity play in the early 2000's, has now transformed into a value added, innovation driven and technology-based industry. Extensive use of plastics in packaging has contributed to the industry's success story, given its virtues of light weight, cost effectiveness and possibility of innovations.

6.3 CRISIL Research estimates the Indian Packaging Industry at nearly Rs. 1,290 billion in Fiscal 2017, up 2.5% on year to year basis. In packaging, the Polymer Packaging, which is the largest segment (62% in Fiscal 2017), increased by 3% during the year. Metal and Paper packaging increased by 1–2% while Glass witnessed a decline of 1% owing to pricing pressure and decline in volume on account of substitution in non-alcoholic segment. CRISIL predicts Packaging Industry to grow by 7–7.7% in Fiscal 2018 and Polymer Packaging also to grow at 7%. The next three years are also expected to show growth rates of 7–8%.

6.4 The share of various packaging materials in India, as per CRISIL Research, is as under:



7. REGULATORY FRAMEWORK

7.1 Indian packaging sector is loosely regulated with no specific restrictions on manufacturing and sales of packaging products. Private companies of domestic origin as well as global packaging companies currently operate in the sector. Entry of global packaging manufacturers is through acquisition of Indian companies as regulations regarding transaction (acquisition/ merger/ Joint venture) involving a global company and Indian company are flexible.

7.2 The Prevention of Food Adulteration Act 1956, Plastic Waste (Management and Handling) Rules 2011 and Food Safety and Standards (Packaging and Labeling) Regulations 2011 are the three major regulations governing food & beverage packaging in India. In addition, manufactures also have to abide by the standards laid out by Bureau of Indian Standards (BIS), notable among them being the directive preventing usage of recycled plastic/ polymer for manufacturing food packaging products.

7.3 As per the existing regulatory framework, recycled plastic based flexible packs cannot be used in food packaging. Further all plastic materials used in flexible packs (like sachets, pouches, vacuum packs) must confirm to quality standards as laid out by Bureau of Indian Standards.

7.4 Manufacturing of flexible packaging products is open to private players and there are no operational restrictions on manufacturers. However, companies manufacturing packaging products for food & beverage industry as well as for pharmaceutical industry have to abide by quality regulations set by the Government of India e.g. Agricultural Grading & Marking (AGMARK) Rules, Edible Oil Packaging (Regulation) Order etc.

7.5 The Food Safety Standards Authority of India (FSSAI) is revising the existing Food Safety Standards (Packaging and Labelling) Regulations, 2011, and it has decided that the same would be divided into three parts, namely regulations pertaining to packaging, labelling & advertisement and claims. FSSAI is expected to release the drafts soon.

7.6 Furthermore, the GST implementation has changed the environment of the industry by converting the country into a single market place. Also, growth in many other industries due to the effects of GST will add to the growth in the Packaging Industry. Most noticeable, sectors like FMCG and e-commerce have benefitted from GST implementation and are projected to see strong growth.

8. MAJOR PLAYERS IN INDIA

8.1 Balmer Lawrie & Company Limited

This is a public sector enterprise and is based in Kolkata. The company is currently under the control of Ministry of Petroleum and Natural Gas, Government of India. The company manufactures plain steel drums, composite drums, lined drums, cylinders and a variety of other industrial packaging solutions. The company has a turnover of Rs. 2762 crores and is the topmost packaging company in India.

Website: www.balmerlawrie.com

8.2 Ess Dee India

Ess Dee India has its headquarters in Mumbai. The company is the largest producer of aluminum foils in Asia. Ess Dee India is also the pioneer in the manufacturing of high-end pharmaceutical packaging products such as Child-Resistant Blister packaging and Cold Form Blister packaging in India.

Website: www.essdee.in

8.3 Max India Limited

Max India Limited is a multi-business conglomerate and its group concern Max Specialty Films manufactures barrier and packaging films. This company has a production capacity of 52,000 tons every year.

Website: www.maxindia.com

8.4 Jindal Poly Films Limited

Jindal Poly Films Limited manufactures polypropylene and polyester films. It is also the largest producer of PET and BOPP films in India. The company's manufacturing unit in located in Nasik, Maharashtra.

Website: www.jindalpoly.com

8.5 Uflex

Uflex manufactures BOPP, BOPET and CPP films, pouches, laminates, polyester chips, holographic films, coated films, etc. inks and adhesives that can be used in every kind of printing. Packaging machines are also manufactured by the company.

8.6 Time Technoplast Limited

Time Technoplast Limited is a leading producer of polymer and packaging products.

Website: www.timetechnoplast.com

8.7 Flexituff International Limited

The company manufactures proof bags, liner bags, baffle bags, single loop bags etc.

Website: www.flexituff.com

8.8 TCPL Packaging Limited

TCPL Packaging Limited is a leading producer of printed folding cartons in India. The other products manufactured by the company apart from folding cartons include plastic cartons, litho lamination, blister paper, printed blanks and outers, shelf ready packaging, etc. It is also one of the largest exporters of printing cartons from India.

Website: www.tcpl.in

8.9 Parekh Aluminex Limited

The company is the largest manufacturer of aluminum foil and aluminum lids containers in the country.

Website: www.parekhaluminex.com

8.10 Ester Industries Limited

The company is the leading producer and supplier of polyester films and engineering plastic compounds in the country. "Uma PET" and the "Estoplast" are the names of the polyester

films and engineering plastics respectively under which they are marketed by the company.

Website: www.esterindustries.com

8.11 TGI Packaging Pvt. Ltd.

It is one of the India's largest manufacturer and exporters of corrugated boxes.

Website: www.tgipackaging.in

8.12 Huhtamaki PPL Flexible Packaging India

Huhtamaki PPL manufactures flexible laminates, films, specialized pouches, cartons, tube laminates, labels, shrink sleeves, rotogravure cylinders, packaging machinery etc. It caters to customers across sectors ranging from food and beverages, personal care to pharmaceuticals, industrial products etc.

9. PROFIT MARGINS

As per CRISIL the segment-wise financials in Packaging Industry are as under:

Operational Parameters	Unit	Glass	Metals	Polymer	Paper
Industry size (2016–17)	Rs. bn	86	174	794	232
Revenue Growth	%	- 5.7	0.0	3.3	11.0
Extent of competitiveness	-	Moderate	Moderate to high	High	High
Growth over next 3 years-CAGR	%	1.0	0.2	8.8	9.0
Growth in last 3 years-CAGR	%	2.6	- 2.1	4.7	3.4

Financial Parameters (2016–17)					
Operating Margin	%	12.1	11.8	13.7	14.8
Net Margin	%	- 0.2	4.1	4.8	8.4
Return on capital employed (RoCE)	%	5.5	9.0	9.5	22.3
Asset Turnover	Times	0.6	0.9	0.8	1.3
Debt/ Equity	Times	1.8	0.3	0.6	0.8
Interest coverage ratio (EBIT/ Interest)	Times	1.9	6.3	3.9	5.0

10. INVESTIGATION TECHNIQUES

10.1 General: The accounts of the manufacturers of packaging materials can be investigated like that of any capital goods industry and the primary/ secondary users of packaging products need to be separately investigated. The primary users are those who buy manufactured machines for their use. Some of the users are large companies, which may have their own captive units also. The secondary users are essentially small-scaleconcerns, mostly in the unorganized sector, who basically convert packaging materials or print the polyester or BOPP films etc. The investigation process would have to be differently oriented in all such cases.

10.2 Examination of Profit Ratios: The assessing officer should examine the book results of the packaging concerns and compare the same with the operational parameters and financial parameters available in the industry as given in para 9 above. These would lead to possible lines of inquiry.

10.3 Acquisition of Machinery: The investment made by the primary user assessee for the purchase & installation of various machines should be enquired into. Such assessee do not import or buy all the ancillary machines from the same source as these can be acquired locally also. The purchase price of the machinery and installation expenditure should be enquired into from the suppliers of such machinery. In the case of machinery purchased from abroad, the documents of import, various duties paid, mode of payment, channel of payment should be looked into. For this purpose, information should be directly collected and verified with the help of Government agencies/ Departments and various other organisations whose assistance/ channel is used by the assessee for the purchase of machinery. In nearly all such cases the services of specialists/ engineers are required for installation of machinery as per the specification of the manufacturers. A direct enquiry from the agencies providing such services, will give information to the AO with regard to the movement of the machinery from the place of manufacturers to the place of the buyer and the process and date of its installation and other incidental activities.

10.4 Purchases of Raw Material: A major area of manipulation of accounts in packaging units is in the purchase of raw material. The purchases are inflated to reduce profits chargeable to tax. For proper enquiries, first the exact nature & quality of the products being manufactured by the assessee with their full specifications should be obtained. This is because the requirements of raw material is directly dependent on the type of packaging material manufactured by the assessee for different kinds of products as discussed in the preceding paragraphs. There are differing requirements of raw material depending upon the type & quality of the product to be packed, shelf life required, sensitivity of the product to the temperature variation and humidity etc. For this purpose, few pieces of finished goods of the assessee can be examined, analysed and disintegrated, to give an idea of the requirement of raw materials. Alternatively, a test run of the production process can be carried out to ascertain the average input: output ratios of various raw materials required for each category of the finished product. This will also bring out average norms for wastage & by-products. The disclosed consumption/ production can then be verified from the technical brochures of the machine as given out by the manufacturers, and logical conclusion regarding inflation of purchases can be drawn. The Assessing Officer may identify the various machines (model/ type and brand) being used by the assessee. From the website of the machine suppliers he can get the data of raw material consumption, input output ratio, cost of production of packaging material which can be compared with data shown by the assessee. This will be helpful in identifying the issues/ cost elements which need to be examined in depth. Thereafter, disclosed purchases of raw material can be verified from the suppliers of raw material, for both, quantity and price. In the world of flexible plastic packaging a minor reduction in the micron level thickness of layers or quality of craft paper/ metal sheet would give enormous savings to such assessees who have large scale units. Many such machines have an output counter also and records are kept by the machines for repair and service use.

10.5 In case of companies manufacturing packaging products for food & beverage industry as well as for pharmaceutical industry the Assessing Officer should examine their compliance vis-a-vis quality regulations set by Government to find out the likely bogus expense on material not conforming to standards.

10.6 As per the existing regulatory framework, recycled plastic based flexible packs cannot be used in food packaging. If the assessee has claimed such material in expenses, investigation in the same may lead to good results.

10.7 Similarly, if the assessee is claiming loss on account of rejection of packaging materials

which were not confirming to quality standards as laid out by Bureau of Indian Standards/ Consumer, the same should be investigated. The services of the laboratories of the Indian Institute of Packaging can be availed in serious cases.

10.8 Sales of Finished Products: The sales of finished goods to various customers should be directly verified from the data available in the books of the customers. In case of discrepancies/ suppression of sales, the same should be confronted to the assessee and adverse view may be taken where discrepancies are not properly explained by the assessee with reliable evidence. The production, sales and closing stock figures should be matched material quantity-wise.

10.9 In case of packaging user assesses, other than a packaging company itself, if the Assessing Officer has apprehension that out of books sales or purchases are being made in such a scenario he can correlate the quantitative consumption of packaging used in production and packaging used in sales with the amount of production and sales. He can call for details from the suppliers of packaging about deliveries on all addresses controlled by the assessee. In one case in Delhi the investigation wing had called for sales made by various packaging material suppliers to a particular address (instead of sales made to a particular assessee). This exercise revealed that the assessee used to buy unaccounted goods from various suppliers (in fake names and on cash basis) and such goods were naturally transported and supplied to its address only.

10.10 Disposal of Wastage: Most of the ingredients required for the manufacture of packaging material are valuable items. Their cuttings, leftovers etc. carry some value, as these can be recycled to produce the same material once again. Proper accounts of such wastage, should be obtained from the assessee so that income/ receipts from sales of these items is properly charged to tax. For this purpose, the quantitative analysis of raw material purchased & consumed, wastage and finished goods produced should be made. The stock register of the assessee, should be examined. Purchase of raw material, its distribution to various sections of the workshop, semi-finished goods at various stages of the process, production & sales of finished goods, and wastage generated, can be checked with the help of dates recorded in the stock register.

RESOURCE

The Indian Institute of Packaging [http://www.iip-in.com/]. The Institute is an autonomous body in the field of packaging and works under the administrative control of the Ministry of Commerce and Industry, Government of India. It has its Head Quarter at Mumbai and Centres located at Delhi, Kolkata, Hyderabad and Chennai. It also has advanced testing laboratories like Consumer Package Laboratory, Material Testing Laboratory, Optical and Barrier Properties Laboratory, Chemical Laboratory and Transport Laboratory.

REFERENCES

1. 51st Annual Report of Indian Institute of Packaging [www.iip-in.com]. However, the website of Packaging Industry Association of India mentions the growth rate of 22–25% p.a. [http://piai.org/About_Packaging_Sector.aspx]
2. The Future of Global Packaging to 2018, a Smithers Pira report. [https://www.smitherspira.com]
3. https://www.businesswire.com/news/home/20170509006321/en/Trends-Opportunities-Indian-Packaging-Industry-2017-Analysis
4. http://ficci.in/spdocument/20690/Plastic-packaging-report.pdf
5. op. cit.
6. Wikipedia.
7. Crisil Research

CHAPTER

9

Automobile Industry

1. OVERVIEW

1.1 Auto industry is said to be the engine of growth in most developed countries, including in China and India today. Indian automobile industry which was at its nascent stage at the beginning of the 21st century has now become a huge industry that contributes majorly to growth and development of Indian Economy. As per the current statistics, the auto industry's turnover is estimated to be equivalent to:

a. 7.1% of overall GDP

b. About 26% of Industry GDP

c. About 49% of manufacturing GDP

The industry employs 29 million people, directly and indirectly, and contributes to 13% of excise revenue for the Government.

1.2 The auto-industry is a key employment generator in the OEM factory that manufactures the vehicles, in the inbound auto component and logistics industry that makes and delivers components & systems and the outbound logistics and dealer network that sells, maintains and distributes the cars. Every vehicle produced, generates secondary and tertiary employment. The industry generates employment of 13 persons for each truck, 6 persons for each car and four persons for each three wheeler and one person for two-wheelers. It is important to appreciate the sector's multiplier effect on economic activity.

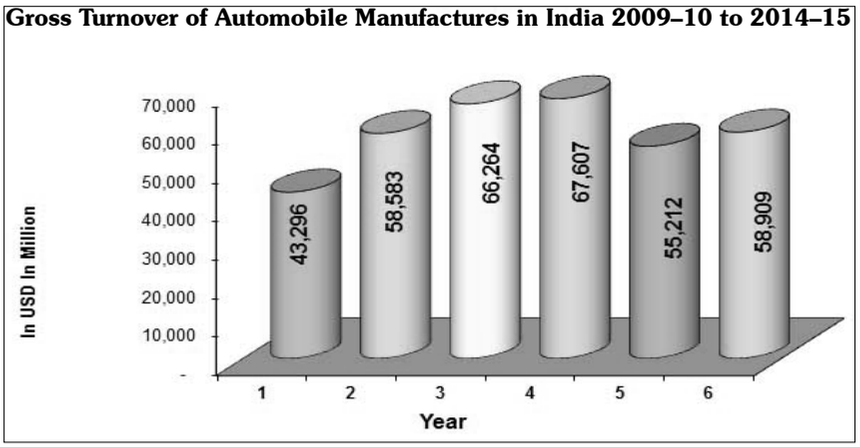
2. PRODUCTION TREND

2.1 Indian Automobile Industry has produced 25,316,044 vehicles including passenger vehicles, commercial vehicles, three wheelers, two wheelers and quadricycle in April-March 2017. Thus, this is one of the largest economic activity of the country with players from both domestic and international markets. Besides the automobile manufacturing, the allied industries like spare parts and accessories like tyres, wheels are also growing.

2.2 Some quick statistics are given below. The details are available from the website of Society of Indian Automobile Manufacturers.

http://www.siamindia.com/statistics.aspx?mpgid=8&pgidtrail=15

2.2.1 Turnover of the Industry over the past years:



2.2.2 Production Trends

Category	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
Passenger Vehicles	31,46,069	32,31,058	30,87,973	32,21,419	34,65,045	37,91,540
Commercial Vehicles	9,29,136	8,32,649	6,99,035	6,98,298	7,86,692	8,10,286
Three Wheelers	8,79,289	8,39,748	8,30,108	9,49,019	9,34,104	7,83,149
Two Wheelers	1,54,27,532	1,57,44,156	1,68,83,049	1,84,89,311	1,88,30,227	1,99,29,485
Grand Total	2,03,82,026	2,06,47,611	2,15,00,165	2,33,58,047	2,40,16,068	2,53,14,460

2.2.3 Automobile Exports Trends

Category	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
Passenger Vehicles	5,08,783	5,59,414	5,96,142	6,21,341	6,53,053	7,58,830
Commercial Vehicles	92,258	80,027	77,050	86,939	1,03,124	1,08,271
Three Wheelers	3,61,753	3,03,088	3,53,392	4,07,600	4,04,441	2,71,894
Two Wheelers	19,75,111	19,56,378	20,84,000	24,57,466	24,82,876	23,39,273
Grand Total	29,37,905	28,98,907	31,10,584	35,73,346	36,43,494	34,78,268

2.2.4 Automobile Domestic Sales Trends

Category	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
Passenger Vehicles	26,29,839	26,65,015	25,03,509	26,01,236	27,89,208	30,46,727
Commercial Vehicles	8,09,499	7,93,211	6,32,851	6,14,948	6,85,704	7,14,232
Three Wheelers	5,13,281	5,38,290	4,80,085	5,32,626	5,38,208	5,11,658
Two Wheelers	1,34,09,150	1,37,97,185	1,48,06,778	1,59,75,561	1,64,55,851	1,75,89,511
Grand Total	1,73,61,769	1,77,93,701	1,84,23,223	1,97,24,371	2,04,68,971	2,18,62,128

3. TAX ISSUES

3.1 Taxing the income of an operator in this industry requires some specific techniques as compared with the rest of the industries as this sector has certain industry specific practices. The business in this sector can be classified into following categories:

a. An Indian owner with production and sales in India with or without overseas fully owned enterprises (Indian MNC).

b. A Joint venture like Maruti-Suzuki with an Indian partner and a foreign MNC

c. A foreign company which has setup manufacturing facility in India.

d. Spare-parts dealers who manufacture sub-assemblies or other spare parts.

It is always beneficial to primarily look at the industry benchmarks and analyze how a particular assessee differs from them and the implications thereon.

3.2 Risk Analysis through Ratio Analysis and Setting Bench Marks

The share of Automotive sector in the Indian GDP is about 7.1%. However, the total share of revenue in the form of direct taxes is quiet low as compared to it's share in GDP. The Assessing officers may adopt the approach of *Risk Analysis through Ratio Analysis and setting Bench Marks* to identify the critical areas in individual cases for deeper scrutiny. An illustration is this respect is given below.

3.2.1 14 major automobile companies (Passenger car segment), which comprised of about 40% of the market share in value and 25% in numbers were selected, using the random sampling technique, for the purposes of Analysis. The objective was to undertake a data driven sectoral analysis of Automobile Industry, identify sectoral benchmarks for various revenue and capital heads and compare individual companies vis-à-vis the benchmarks to flag risks for deeper examination by the Assessing Officers.

3.2.2 Companies selected for the above analysis were: Audi Motors India Pvt Ltd, BMW, FIAT Motors, Ford India, General Motors, Honda Cars, Hyundai Motors, Mahindra & Mahindra, Maruti Suzuki Ltd, Mercedez Benz India Private Ltd, Renault India Pvt Ltd, Skoda Auto India Pvt Ltd, Toyota Kirloskars India Pvt Ltd and Volkswagen India Pvt Ltd.

3.2.3 A list of key essential ratios derived from the analysis of the financials for the above companies taking into account the financial statements (Balance Sheet and Profit & Loss Accounts) for the period F.Y 2011–12 to F.Y 2015–16 was undertaken.

3.2.4 Based on the Ratio Analysis, the following *Benchmarks* were identified for the sample auto companies:

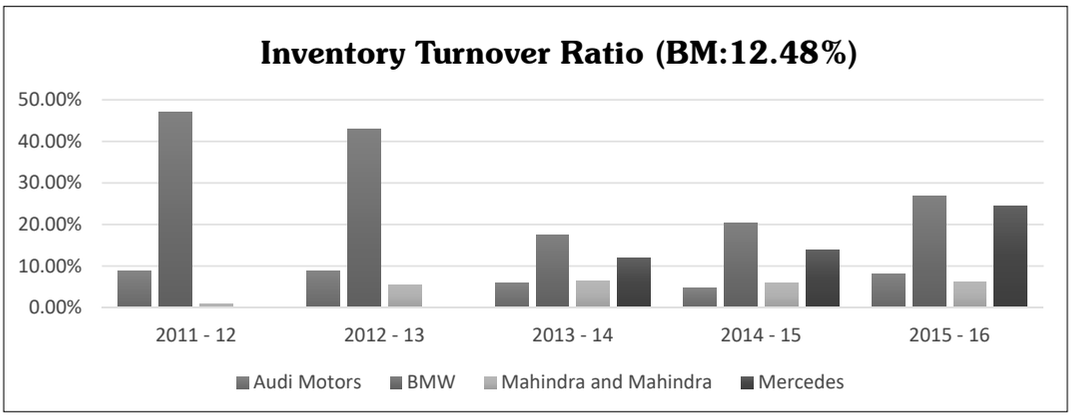
a. **Turnover Ratios:** Debtor Turnover Ratios: 6.09%; Creditor Turnover Ratio: 15.09%; Inventory Turnover Ratio: 12.48%; COGS to Turnover Ratio: 60.58%; Turnover to Capital Employed Ratio: 5.33 times.

b. **Expenses Ratio:** Miscellaneous Expenses to Turnover Ratio: 4.3%; Interest to Borrowing Ratio: 7.29%; Selling Expenses to Turnover Ratio: 4.86%.

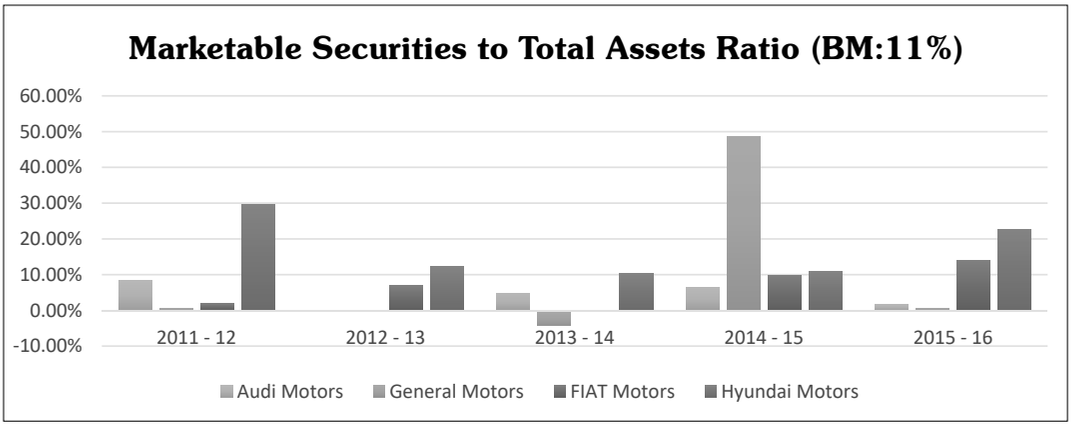
c. **Others:** Debt-Equity Ratio: 1.68 times; Marketable securities to Total Asset Ratio: 11%, Advance Tax Paid to Total Tax Liability Ratio: 51.2%; Profit (EBIT)/ Turnover Ratio: 5.1%.

As indicated above, the benchmark was derived for the sample companies on the basis of their financial statements for the five years. The ratios may vary when a different sample and segment of the Auto sector is analyzed. Ratios may also change depending on the age of the companies and their business structure. Ratio Benchmarks are indicators for greater investigation.

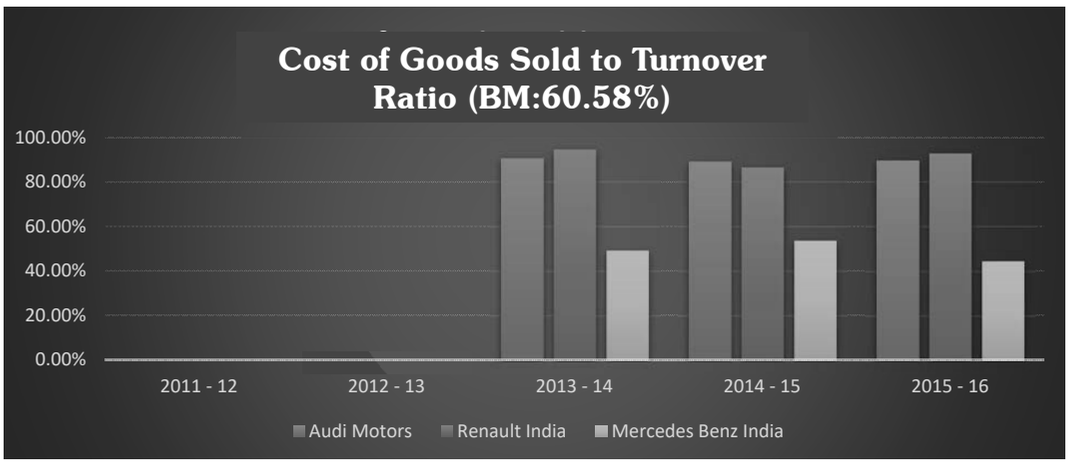
3.2.5 Risk Analysis: Company results compared to benchmarks & Risks are flagged as under:



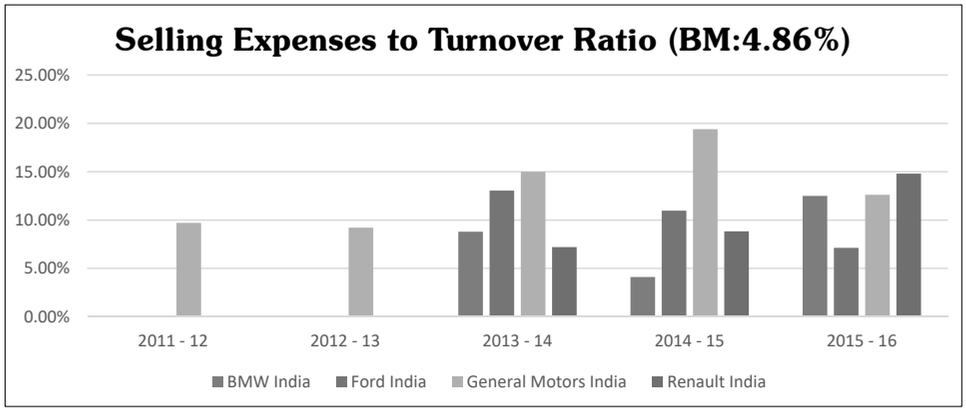
3.2.6 Tax Implications: Higher Inventory Turn Over ratio was found in the cases that may indicate overvaluation of inventory & fictitious purchases. It is a general trend of the Industry to keep an average 5% to 10% of total turnover as inventory. The above table indicates the ratio exceeding 10% in many cases implying inconsistency in inventory valuation policy.



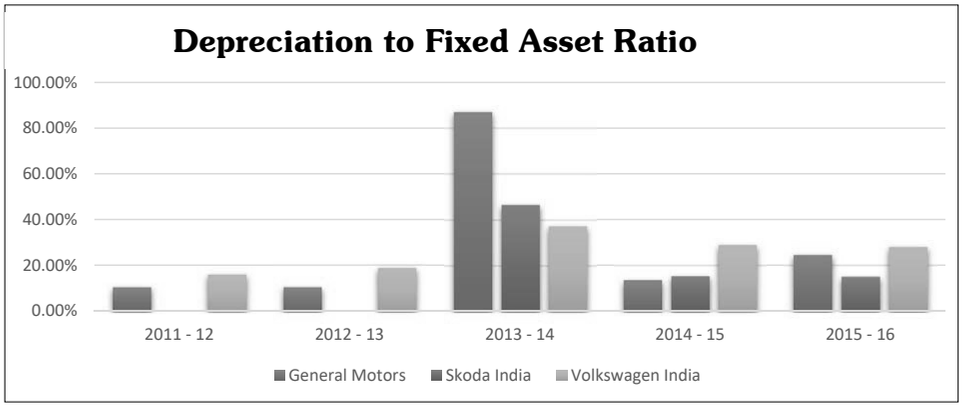
3.2.7 Tax Implications: Higher Marketable Securities to Total Asset Ratio was found in cases that may be examined for diversion of borrowed funds to non-business purposes. As may be seen, in one case, while for the rest of the year this ratio was less than 1%, in a year it was as high as 48.75%, which clearly needed deeper examination.



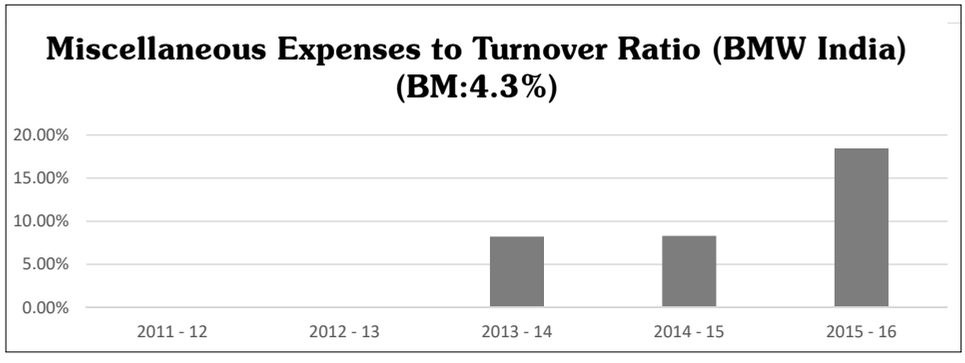
3.2.8 Tax Implications: Higher Cost of Goods Sold to Turnover Ratio was found which may be analyzed for over invoicing. At least in two cases this ratio was as high as 90% and above as against industry trend of 60–70%.



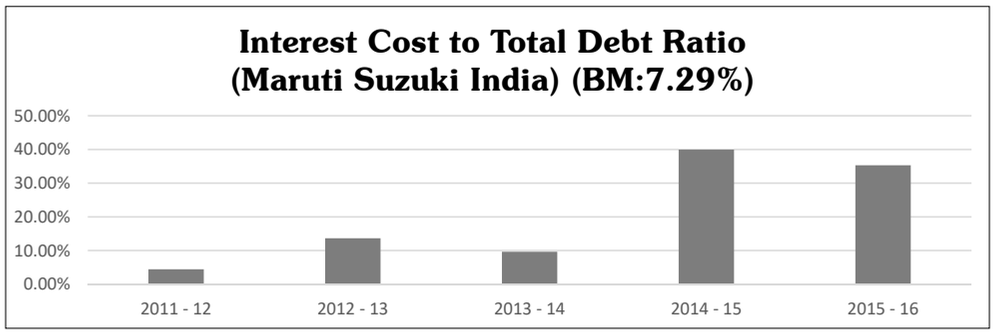
3.2.9 Tax Implications: In cases found with higher selling expenses to turnover ratio, the nature of expenses may be examined from Section 37 point of view. The normal trend followed in the automotive sector is to incur selling and marketing expenses ranging about 6 to 8%, especially for the luxury car brands.



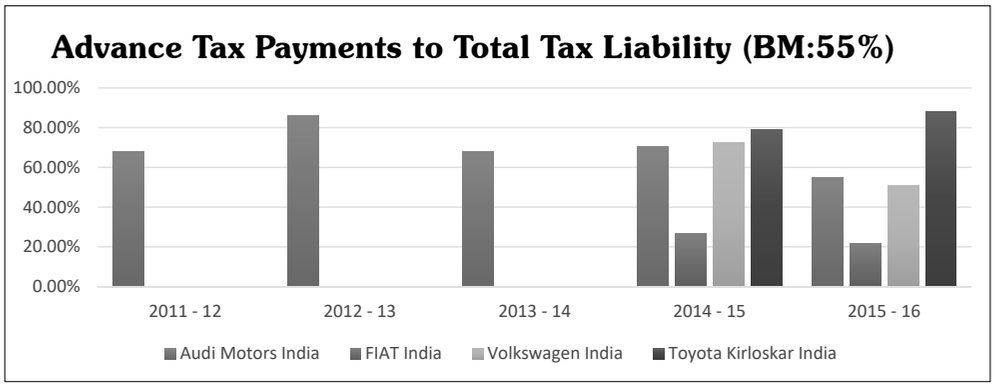
3.2.10 Tax Implications: Depreciation may be used as a tool for excessive tax-deferral. The Depreciation to Fixed Asset Ratio may be examined by the AO for this purpose. In the year 2013–14, the Companies Act, 2013 was introduced and depreciation calculation was supposed to be done as per Schedule II on the basis of the useful life. It was observed that many assesses took this opportunity to reduce the book profits by depreciating up to 90% of the assets and thereby deferring taxation..



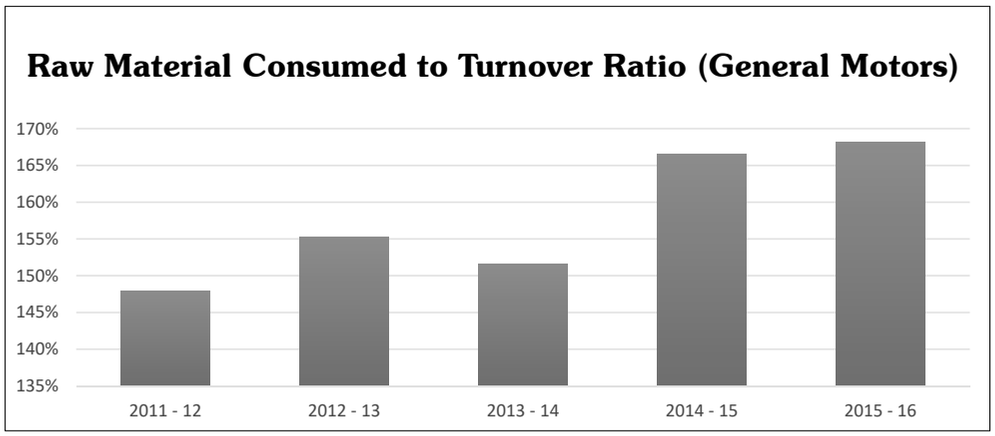
3.2.11 Tax Implication: Higher than 5% of Miscellaneous Expenses vis-à-vis turnover should be examined. At least in one case, this ratio was as high as 18%, which needed further examination



3.2.12 Tax Implication: Interest cost above market rates may be examined. The total interest cost incurred by a company was found to be far above the market rate of interest. On verification it was found that the company has debts in foreign currencies, which are supposedly repaid at such higher interest rates. The genuineness of such payments may be further assessed.



3.2.13 Tax Implication: Lower Advance tax payments to total tax liability Ratio may indicate tax deferral that may be pursued for advance tax monitoring purposes.



3.2.14 Tax Implications: Higher Raw Material Consumed to Turnover Ratio may indicate fictitious purchases or expenses related to manufacturing. In one case it was found to be as high as above 150% in successive years.

3.2.15 After the AO has compared the assessee's financials with the industry benchmarks, he should look in to some of the most common issues encountered in the cases of automobile industry which are discussed hereunder.

4. WARRANTY PROVISION

4.1 The claim of expenditure in the form of warranty provision is one of the most contentious issues. The Hon'ble Supreme court in the case of M/s Rotark Controls P Ltd ruled that this should be allowed as deduction if the computation of the warranty provision was carried out in a scientific manner. IND AS-37 recognizes the warranty provision as a contingent liability and provides a mechanism to compute the value of the warranty claims by considering the discount rates. This is akin to the valuation by an actuary in valuing the insurance risks. Thus, the liability of the manufacturer to provide for warranty claim is a risk that can be estimated by valid scientific methods.

4.2 Therefore, the warranty provision estimates should be examined to see if there is any scientific or actuarial valuation of the liability. In addition to this, the AO should examine the accounting method followed by the assessee. Once the provision made in the books is allowed, then all the expenses that arise out of warranty claims should be debited to the provision account. The unutilised provision, if any, that remains after the warranty period shall be written back at the expiry of the period.

4.3 In certain cases, the assessee sells additional extended warranty. The premium received for the extended warranty may be for a period of one or more years. The assessee should offer all the amount of premium so received as income in the year of actual receipt. In many cases, this is not done. The assessee may resort to offering only a proportional quantum of the premium as income of the year and carry the balance for the remaining years. This is not to be allowed as the assessee is claiming all the warranty provision as expenditure in the year the product is sold.

4.4 There are several components that are purchased by the auto manufacturer from the OEM vendor. These components are covered by warranty offered by such vendors as part of the contract. Any expenditure on account of failure of these components shall be first incurred by the assessee and subsequently claimed from the supplier of the failed component. This should be written back. For these reasons, the provision movement account needs to be examined.

5. CLAIMING CERTAIN EXPENSES THAT ARE NOT RELATED TO BUSINESS

5.1 In many cases the assessee manufacturer makes payments to business associates for certain services received. This activity needs to be examined closely. The agreement between the assessee and the person receiving the payments should be examined. Some of these payments would be in the same nature for which payments would be made separately to other parties. In all these cases the specific activity performed by the person receiving the payment should be examined. The claim of such payments made should be allowed only after establishing that the services were actually rendered.

5.2 For this purpose, the AO may examine if the associate has the expertise, manpower to render the service and whether such manpower was available at the locations where such services were delivered. All the mails and correspondences between the parties may be a good source to determine if there was any service rendered. In many cases where the transactions are either International Transactions or Specified Domestic Transactions, the same shall be examined by the TPO. There may be other parties to whom such payments are made that shall be examined by the AO. In certain cases, acquisition of fixed assets like building needs to be looked into. There have been a few instances where the assessee manufacturer makes payment to acquire fixed assets that are far in excess of the actual cost of asset acquired. Therefore, additions to fixed

assets may be examined to see if the payment made was in excess.

5.3 Some of the expenditures of this nature that were claimed but disallowed during the assessment are discussed below.

5.4 Shared Services Cost: In certain cases, the service provider may be carrying on some activity like maintenance of server, HR services, Market Research etc. These persons do a lot of activities for themselves and purportedly for others also. The assessee manufacturer making payment to these service providers stating that some of the services were shared may still have in their payroll persons having technical expertise to carry out the same functions. All such cases of this nature should be examined to see whether such services were actually needed by the assessee. The place at which such services were rendered should be examined. All the related documents like agreements, contracts and communications that show that the services were rendered and receipts acknowledged should be examined.

5.5 Reimbursement of Expenditure: The reimbursement may be outbound or inbound. In most cases, it is examined by the Transfer Pricing Officer. In a case where outbound reimbursement is made to an overseas party, the AO shall examine if the other party charged the assessee on cost-to-cost basis. Wherever the assessee fails to provide necessary proof that the overseas party did in fact charge the assessee on cost-to-cost basis, and if the assessee did not withhold tax, the AO shall examine the issues for possible disallowance *u/s* 40 (a)(i) of the Act.

5.6 Testing and Development Charges: The assessee manufacturer having a technology partner who receives royalty for the patent and trademark may be making a payment to another party for testing and development. This needs to be examined. The Associated enterprise is the owner of the patent of the product. The assessee makes all the required payments to the AE. In such a case, the product development should be the primary responsibility of the AE. Any expenditure by the assessee in this regard should be looked into carefully. In some cases, it may call for disallowance, as the payment is not for the business purpose of the assessee. In most cases, the TPO would also examine this as the assessee manufacturer provides some additional services to the AE and the amount is to be recovered from the AE with due profit margin for similar business services.

5.7 Certain Write Offs: In some cases, the assessee writes off certain amounts from the account payables being the creditors for capital assets. This usually happens in the case of retention money. Such occurrences may have to be examined. The assessee may reduce the amount of write off from the opening WDV in the corresponding block of assets. As per the decision of Hon'ble Supreme Court in the case of T.V. Sundaram Iyengar & Sons Ltd (222 ITR 344 (SC)), it has been held that the amount, which has been received, may be of revenue in nature at the time of the receipt even though the same may be treated as capital item in the books of accounts. In such circumstances, the AO shall examine if by the nature of such a write off, whether the amount can be considered as profit *u/s* 41(1) of the Act.

5.8 Remittances Abroad: All remittances abroad should be reported in Form 15A. These forms should be examined for remittances where no withholding of tax was made by the assessee. Full and complete details of such transactions should be obtained. Details such as the person to whom such payments are made, details of any agreement as a result of which the payments are made, the reasons why the assessee considered that no withholding of tax is required, etc. are to be looked into.

5.9 In all cases where the withholding of tax was not made as the payment was not taxable as per the DTAA between India and the tax territory 1, further investigation may be needed. Efforts may be taken to identify the overall holding company. The details of the company to which the payment was made, such as the location, address, number of employees, qualification of them, copies of board notes of the overseas

company and the assessee company are relevant information in this regard. If it is seen that this amount was in turn immediately transferred to the ultimate holding company in another tax territory 2, it may call for further enquiry. For this purpose, the AO may make a reference via FTTR of CBDT. If the AO can establish that the entity to which the payment is made is a paper company and the beneficial owner is the holding company in another tax territory and all management decisions are made by the holding company, then the AO can pierce the corporate veil and examine whether the Tax Treaty between the India and tax territory 1 shall still apply to the transaction between or the treaty between India and tax territory 2 shall apply.

6. INVESTIGATING OTHER TRANSACTIONS

The other transactions like Receivables/ Payables, reimbursements/ recoveries, corporate guarantee, etc, that are common to other industries/ sectors. Therefore, the techniques of investigation are common. Claims like forex gain/ loss as operating/ non-operating, customs duty adjustment, idle capacity adjustment, working capital adjustment, etc., are also common to other industries/ sectors and the techniques of investigation of these issues are also common.

7. TRANSFER PRICING ISSUES IN AUTOMOBILE SECTOR

7.1 When the Indian economy opened for entry of global players in early nineties, many leading global car manufacturers saw a huge opportunity in India for the following reasons:

a. To capture India's growing car market. It has one-fifth of world population. Its increasing middle-class population was aspirational.

b. India has many location advantages such as:

(i) Cheap land,

(ii) Skilled manpower availability at less cost (at about 20% of cost in developed countries)

(iii) Free or cheap water (about 4 lakh liters are required to make a small car),

(iv) Cheap electricity (rates are 1.5 times in USA, 2.4 times in France, 2.5 times in USA, 3.25 times in Japan and 4.4 times in Germany), and

(v) Liberal Govt. subsidies like refund of VAT, duty drawback, etc.

With the above advantages, they could make quality cars at low cost

c. With low cost they can capture a big market in India besides deriving maximum profit on sale in the global market. So the foreign car manufacturers created their subsidiary companies in India. They:

(i) Entered into agreements with their subsidiaries to grant technical know-how, etc. for making of cars for a royalty @ 5 to 8% of sales effected by the subsidiary. They also collected a lump sum fee at the time of entering into the agreement.

(ii) Sold, at a profit, machinery and equipments required for setting up of manufacturing plant in India.

(iii) Sold, at a profit, raw material and consumables needed for manufacturing.

(iv) Sold, at a profit, CBU (Completely Built Units) cars or CKD (Completely Knocked Down) parts of cars, for direct sale or sale after assembly respectively.

(v) Sold, at a profit, spares required for the sales of cars made already.

(vi) Provided technical services to their Indian subsidiaries and charge more than the cost.

(vii) Purchased the cars and spares manufactured in India, mostly at rates

less than their domestic selling rates. Sold these cars in the global market with a high margin and still capture the global market easily because of their low cost in India which gave them the competitive edge when compared to other manufacturers who do not have subsidiaries in countries like India.

(viii) Collected their receivables from their subsidiaries in time, but did not pay within the normal credit period and force them to avail external loans at market rate of interest.

(ix) Granted interest-bearing loans to Indian subsidiaries, at rates much higher than the rates at which they get such loans, thereby eroding the profitability of the Indian subsidiaries.

(x) Entered into cost contribution agreements with Indian subsidiaries without extending the benefits proportionate to their contributions.

7.2 Many a times, while the foreign AEs reaped profits in each one of the above transactions, the Indian subsidiaries were not able to get even 5% of sales as its profit margin for the entire manufacturing, marketing and distribution functions carried out by them. Many a times the subsidiaries posted losses year after year. The above scenario is not only applicable for OEMs of vehicles but also for TIER-II and TIER-III suppliers.

7.3 All the ten activities listed above call for benchmarking with regard to arm's length price (ALP). Most of these transactions are reported in Form 3CEB but the transactions in receivables/ payables are not reported directly by most of the assessees on the ground that their main transactions in imports/ exports are reported and receivables/ payables are only a consequence of their main transactions. Yet another transaction that is not at all reported by any assesse is incurring of expenses by the Indian taxpayers towards Advertising, Marketing and Sales Promotion (AMP) that benefits the overseas AE in the form of increase in the value of brands owned by the AE.

7.4 So, during T.P. audit, the affairs of the Indian taxpayer and the overseas AE are required to be investigated in order to make proper benchmarking of the reported transactions and also to discover unreported transactions and benchmark the same. The techniques of finding out the actual profile of the assessee and investigating different transactions are discussed hereunder.

7.5 Actual Profile of the Assessee: Profiles of the Indian assessees can be of several types such as licensed manufacturers, contract manufacturers catering to the Group's markets outside India, distributors, joint ventures or technology collaborators, etc. Since the benchmarked margins will be in proportion to the grade of their profile, the assessees tend to camouflage their real profile and present a picture of a lower profile in their T.P. study. For example, in one case, the assessee claimed that it is merely distributing the earthmovers imported from AE and, therefore, its margin was low. But when the invoices were verified it came to light that it was actually importing parts of earthmovers and only in India they were assembled and sold as earthmovers to the ultimate customers. This additional function involving additional assets and risks entitle it to a higher margin than that of a distributor. This fact could also have been brought out by examining the expenses debited to the P&L account. The assessee ought to have debited substantial expenses towards assembling camouflaged as sub-contract expenses or under some other head of similar nature.

7.5.1 A contract manufacturer need not pay royalty for the technology supplied by the AE for whom it is the contract manufacturer. If royalty is paid by a contract manufacturer, it needs to be probed thoroughly. Similarly, the risks, such as inventory risk, marketing risk, etc., actually undertaken by an assessee, claimed to be a contract manufacturer, needs to be investigated. The higher the risk, the higher should be the margin.

7.6 Royalty Payment: In an independent and uncontrolled situation, any company would be ready to pay for an intellectual property right or an intangible asset if it sees a long term benefit from the usage of the same and it is not available to it otherwise. In the automobile industry, royalty payment is claimed towards royalty for technology, for brand name or logo, or on account of both technology and brand name. The contractual terms in the royalty agreement need to be carefully examined. It needs to be seen whether royalty is for patented technology or for general technology and if it is for patented technology then whether during the relevant previous year the patent was still valid. (The validity period of a registered patent is only 20 years). The way to examine is to undertake a benefit analysis for both the technology and the intangibles being transferred. OECD's latest guidelines acknowledge this concept and stipulate that commercial rationality into such decisions of payment of royalty needs to be examined.

7.6.1 Yet another issue in royalty could be the rates at which royalty is paid. A leading automobile manufacturer was actually paying 5% royalty on domestic sales and 8% royalty on export sales. It could not substantiate the reason for paying an additional 3% on export sales when the same model car with almost the same features was sold in both domestic and export markets. Its only contention was that RBI permitted a maximum royalty of 5% on domestic sales and 8% on export sales. The assessee benchmarked the payment by combining the royalty amount and the sales value and claiming it to be within arm's length. When the payments were segregated and benchmarked, it turned out that royalty payment of 8% was outside the arm's length.

7.6.2 One more issue in royalty could be the method of computation of royalty as per the Clauses in the royalty agreement and also as per RBI norms. According to RBI norms, the cost of standard bought out components should be reduced from the base for computation. Many assessees are not doing it. There could be other deviations from the method of computation, which need to be checked.

7.7 Import of Machinery and Equipment

7.7.1 Some assessees adopt CUP or Other Method and benchmark by comparing valuation made by Customs authorities. Since the focus of valuation by Customs Dept. is entirely different, it cannot be mechanically accepted. The issue becomes complex in the case of import of second hand machinery from AEs. Some assessees furnish valuation certificates given by approved valuers by adopting CUP or Other Method. Many a time such certificates are sketchy, lacking credibility.

7.7.2 By collecting details such as invoice price at the time of purchase of new machinery by the AE and the details of depreciation claimed, benchmarking has been done by many TPOs. But the appellate authorities have not upheld such approach. The necessity for importing second hand machinery and the cost of similar new asset in India are some of the factors that need to be gone into. Referring the valuation to the Valuation Cell of the Dept. is another possibility.

7.8 Import of Raw Material: In several cases it has been found that the while the raw material is supplied from one country (as per bill of lading that mentions the port of discharge), billing has been done from another country which is a low tax incidence country. Those cases are fit cases to seek, under exchange of Information, details of activities and financials of the AEs. Purchase bills, terms and conditions of supply and payments, mode of transportation and trail of payments made are significant nodes of investigation in this transaction.

7.9 Intra Group Services (Technical Fees, Management Fees, Warranty Cost): These intra group services are to be examined to ensure that such payments are not used to shift profits under the garb of some service availed from AE especially if it is situated in a low tax incidence

country. The service should not be in the nature of share-holding activities and also should not be duplicative in nature. OECD's revised guidelines stipulate that MNCs have to demonstrate via documentation the benefits derived from such intragroup services.

7.10 Import of Completely Knocked Down and Completely Built Units: In view of the lesser import duty on CKD parts, many assessees prefer import of CKD parts to CBUs. The discussion under "import of raw materials" is equally applicable for both these transactions.

7.11 Import of Spare Parts: While some assessees aggregate this transaction along with their main transaction of import of raw materials/ CKD/ CBU, some others benchmark this transaction separately by comparing segmental margins with that of comparables. TPOs may try to get segmental results in all cases. While computing segmental margins, the allocation keys need to be checked carefully.

7.12 Export of Vehicles, Components and Spares: The approach of the assessee in such exports is to aggregate all transactions and conclude that since at entity level the financial results shown are comparable to companies involved in similar line of business, exports should also be treated at arm's length under TNMM. This approach has to be thoroughly examined, especially when exports are to AEs located in low tax incidence countries.

7.13 External Commercial In-Bound Loans: Determination of ALP of this transaction is generally done by the assessees using CUP (Comparable Uncontrolled Price) method, adopting the rates of LIBOR/ EURIBOR/ PLR, whichever suits them. Comparability of the inbound loan international transaction is decided by its price that is normally expressed in terms of rate of interest at which it is available. However as per Delhi High Court's decision in the case of Cotton Naturals, which has been accepted by the Department, the currency in which the loan is to be repaid is the deciding factor in determining the applicable rate.

7.14 Cost Contribution Agreements: TPOs have come across international transactions of cost contributions from the Indian jurisdiction where such expenses have been debited to the P&L account. However, during TP audit, the assessees have not been able to substantiate the expenses in terms of the benefits that are likely to accrue from such expenses. In the absence of any such demonstration in the TP documentation, the value of such cost contribution arrangements would be suspect.

8. INVESTIGATING THE TRANSACTION OF AMP

8.1 Since this transaction is not at all being reported by any assessee, TPO should first start by looking at the figure of expenses booked under the head "advertisement, marketing and sales promotion". If it is substantial when compared to the sales figure, then he needs to call for the full break-up and details of the entire expenses.

8.2 The second step is to segregate the selling expenses booked under the head AMP since it is a common practice to debit expenses like sales commission, dealer commission, dealer events, promotional tours for dealers, etc, under the head "AMP". A thorough demarcation of the expenses is to be made, separating selling expenses from the brand promotion expenses through advertising, marketing and promotion of brand. Selling expenses can be accepted as wholly incurred for the benefit of the assessee. Generally, there is little dispute in the demarcation of expenses between selling expenses and others (brand promotion expenses).

8.3 The assessees claim that the brand promotion expenses cannot be treated as incurred for the benefit of the AE because if the brand is promoted in the local market, sales are also be promoted here. Hence, any increase in brand value is merely incidental.

8.4 Therefore the third step is to analyze the non-selling expenses. By going through the actual advertisements placed in various media,

the claim of the assessees that the advertisements are meant to promote sale of their products and not the brand of the AE can be verified. If the advertisements were placed in global events, then, certainly most of the benefits would accrue to the overseas AE and not to the Indian assessee. After analyzing the above, a fair allocation of brand promotion expenses can be accepted as incurred for the benefit of the assessee. The share of brand promotion expenses incurred for the benefit the AE can be considered for adjustment.

8.5 The fourth step is trying to establish AE's control over the AMP functions of the assessee to establish that it is an international transaction. The following details need to be analyzed to arrive at the decision whether the AMP spend was incurred by the assessee on its own or at the instance of the AE:

a. Contents of the advertisements and who designed it
b. Periodicity of release of advertisements and who decided it
c. Who negotiated the price with third party advertisers
d. Geographies in which it was released and who decided it
e. Occasions of release of the advertisements and who decided it
f. Agreement between the assessee and AE with regard to advertisement or brand promotion
g. Group's strategy with regard to promotion of its brand
h. Agreement, if any, between the AE and the advertiser
i. Copies of MIS reports to the AE
j. Data gathered from the media campaign undertaken by the AE
k. Studies carried out by AE on brand promotion

8.6 In one case, the agreement between the assessee and the AE provided that the content, periodicity, etc, are to be decided only by the AE. In another case, the royalty agreement specifically provided that the Indian taxpayer should take steps to popularize the brand. In yet another case, it was admitted in the financials of the Indian taxpayer that it is the group's strategy to spend heavily during the relevant previous year to promote the brand. If the payments to third party advertisers are determined by the AE, it can be deemed to be a separate international transaction and benchmarked.

8.7 On the basis of evidence gathered from the above marshalling of the facts, it is likely to be clear as to who is the actual controller of the activities. It will be easy to establish if all the activities are carried out under the control and guidance of the owner of the brand, irrespective of the fact whether the assessee is in a position to reasonably benefit from such expenditure. Once it is established that the assessee is not the sole entity controlling AMP expenditure, it would be easy to categorize the expenditures incurred under the guidance of the parent MNC as an international transaction. Similarly, it will also be relevant to compare these expenses with such expenses existing in the industry. This can be used as an evidence to suggest that there is a tendency to disproportionately book expenditures in the territory *viz-á-viz* the other companies operating in the same field.

8.8 Fifth step can be taken to strengthen the rationale for AMP adjustment by finding out the actual increase in the value of the brand owned by the AE during the relevant financial year. There are globally renowned brand valuation expert agencies such as "Interbrand" which comes out with rankings and values of various reputed brands annually. There are several regional/ national level brand valuation agencies. By gathering necessary details, the actual accretion to the brand value can be computed. One MNC has admitted in its report to the shareholders the increase in the value of brand as per "Interbrand" valuation, making the

job of TPO easy to refer to that valuation and propose the AMP adjustment.

8.9 Hon'ble Delhi High Court, in Sony Ericsson Mobile Communications India Pvt. Ltd. in ITA No.16/ 2014, held that quality control is the most important element, which can mar or enhance brand value. Hon'ble ITAT, Madras, in the case of M/s. Hyundai Motor India Ltd., in ITA NO.853/ CHNY/ 2014, 563/ CHNY/ 2015 & 842/ CHNY/ 2016 for AY 2009–10 to 2011–12, held that "*increased visibility to this trade name does contribute to increase in brand valuation of the brand name.*" The visibility will happen through sale of cars carrying the name and logo of the brand of foreign AE and through advertisements. As per the International Accounting Standard (IAS) 38, the advertising and selling expenses are held to be part of brand-building activity related to expenses made on behalf of the parent company being the legal owner of the IP, knowhow and technology.

8.10 In view of the above, the benefit that has accrued to the AE in the form of increase in brand value during the year can be attributed to the global sales (quantity and/ or value) and global AMP expenses. The figures for the global sales and global AMP expenses may be obtained, either from the assessee or through the exchange of information route, and the share of Indian assessee computed. An equivalent proportion in the increase in value can be directly attributed as an accrued benefit to the AE on account of AMP spends of the assessee.

9. INVESTIGATING SEGMENT-WISE PERFORMANCE

9.1 The assessees tend to present a consolidated picture of its operating margin and claim it to be within arm's length. But if the performance of different segments is analyzed, the real picture will come out. In one case, the assessee claimed that its overall margin was within arm's length. The assessee was selling its car in domestic and export markets. In the domestic market it was selling to third party customers. In the export market it was selling only to AEs. When the selling prices in domestic market and export market were compared, the prices in export market were found to be too low. Even after considering the differences on account of duty drawback, etc, applicable only to export market, the price was still found to be low warranting an adjustment.

9.2 If the assessee is selling to its AEs and third parties in export market, analysis of margins in those two segments could help in benchmarking its margins in AE segment.

9.3 Sometimes, analyzing the performance in car segment and spare parts segment will reveal that the high margins earned in spare parts sales to third parties is used to cover up the poor margins in car sales to AEs, warranting an adjustment towards car segment margin.

9.4 In the case of a new heavy commercial vehicle manufacturer's case, the assessee claimed that its loss in the initial year is due to market penetration efforts in India. When the bill of material for different models of vehicles were called for and examined it was found that all the vehicles were sold at a loss. But the percentage of loss varied from model to model and the vehicles, which were exported to AEs, had a higher percentage of loss when compared to that of the vehicles sold in India. The assessee stood exposed. Same modus operandi was found out in the case of a car manufacturer also.

9.5 The vital issue in analyzing the segmental result is that these segments are usually not part of the financials and they are prepared exclusively for transfer pricing purposes. Therefore, the allocation keys used play a vital role in projecting the margins as desired by the assessee. The appropriateness of the key used for allocation of different expenses should be examined meticulously.

10. USAGE OF EXCHANGE OF INFORMATION

Many of the details discussed above can be collected by using the route of exchange of information. e.g. financials of AE to know its margins, group expenditure for AMP, validity of patents registered by AEs, etc. Therefore, this route should also be Utilised fully.

CHAPTER

10

Bicycle Industry

1. INTRODUCTION

A very large share of the India's total population is based in rural areas, where the bicycle is an important mode of transportation. It is also an important component of urban transport as well as a mode of transport for children. Bicycles have a role to play in supporting the mobility and livelihoods of the urban poor in making public transport accessible to more people at lesser cost and curbing harmful automobile emissions. The growing urban population base and rising demand for roadster bicycles from rural population is projected to drive growth in the country's bicycle market in the ensuing years. India is the largest manufacturer of bicycles in the world after China. India produces approximately 10% of the world annual bicycle production. The annual domestic demand of bicycles in India is approximately 17 million units out of which around 2.5 million units are government demand for the various welfare schemes. As per a study by the National Council for Applied Economic Research (NCAER), there were over 12 crores bicycles on the Indian roads in 2015, only a marginal increase over the past years. However, the Bicycle industry itself has seen a growth rate of 8% per annum for the last 15 years. The future prospects of this industry are also considered to be bright. For an Indian, the first consumer durable to be purchased is a wrist watch and the second most desired consumer durable is a bicycle. Considering this factor, demand for the standard roadster model of bicycle is directly linked with the increase in population and the rising purchasing power of the poor in the country. The Bicycle industry is expected to continue to grow at an average rate of 8% or more per annum from the year till the year 2022.

2. There are some unique characteristics of this industry, which have a determining influence on the structure and the manner in which cycles are produced and sold:

a. There is a high degree of *ancillarisation* where parts and components are sourced out to small units. Some of the big manufacturers have slowly developed backward integration but still large number of components and parts are obtained from ancillaries, some of which operate in the informal sector.

b. There is a strong *brand identity* with respect to the assembling and marketing of bicycles. Four of the largest manufacturers in the country, namely Hero, Atlas, Avon

and Tube India (TI) account for more than 93% of the annual production.

c. The manufacturing process is divided into a number of sub-assemblies. There are a large number of cycle parts and component manufacturing units which are involved in manufacture of the subassemblies.

d. There is an exclusive distribution network for bicycles wherein distributors and retailers sell only bicycles and do not keep any other consumer durable in their stores.

The exclusive kind of distribution channel and the strong brand identity makes it very difficult for new entrants to penetrate this industry. Thus, the structure of the industry has a strange kind of dualism. On the one hand are the large cycle manufacturing companies like Hero Cycles, Atlas Cycles etc.. and on the other side of the spectrum are small or medium sized ancillary units supplying some or the other component to these companies. This implies that the large companies involved in the manufacture of complete bicycle have a stranglehold over the small scale ancillaries, which places them at a great advantage in any bargain involving these two types of players.

3. Process of Manufacture: A bicycle consists of more than 500 different components and parts. Its manufacturing process involves several subassemblies like frame, fork, handle, pedal, mudguard, brake set, chain wheel and crank set, saddle, rims, hubs etc. The standard procedure is to assemble the main components on the workshop floor and send them in batches to the main assembly shed. All the major manufacturers dispatch the cycles in knocked down kits which are assembled at the retail outlets. This form of dispatch is necessitated by considerations the transport cost. Some of the major sub-assembling processes in the manufacture of a cycle can be described as follows:

a. Frame and Fork: Steel tubes are usually procured from the market already cut to the required sizes. Sheet metal components for fork sub assemblies are produced in the unit or purchased from the market. The tubes are aligned with the components and fabricated in the tubular department through various operations, brazed up and machined to the requirement. Afterwards these two sub-assemblies are bonded together. The bonded subassemblies are painted and finished and sent into shed for final assembly of the cycle.

b. Handle Assembly: Handle is assembled in the processing shop, brazed up, bent and machined as per design specifications. Then they are polished and nickel chrome plated. Handle along with its small components are assembled and wrapped in the assembly shop.

c. Brake Assembly: Brake components, purchased as well as processed in the press shop, are barreled, polished and plated as per requirements. These are then finally assembled and wrapped for dispatch.

d. Pedal Assembly: Sheet metal components of the pedal are produced in the press shop, these are barreled and plated. All the components are assembled along with few components bought from the market and then finally packed.

e. Chain Wheel and Crank: Chain wheels are produced from cold rolled strip through various press tools in the press shop and then polished and plated. Bought out crank forging are machined through various stages and then polished and plated. Both are assembled, wrapped and packed finally.

4. Main Machinery Required: The machinery installed in any cycle manufacturing unit depends on its dependence on ancillaries for different components and the degree of automation in the manufacturing process. But a typical unit would have the following main machines:

a. Power presses.

b. MIG welding sets

c. Gas brazing sets

d. Painting shop

e. Rim rolling mill
f. Mudguard rolling mills
g. Dip brazing furnaces
h. Debrassing plant
i. Electroplating plant
j. Jigs and fixtures and special tools.
k. Some of the manufacturers have installed robotics processors/ automatic processors for different subassemblies, particularly frame and fork sub-assembly.

5. Cost Analysis of Different Components of a Bicycle: It is difficult to provide a generalised cost analysis of the components of a bicycle because of the large number of models available in the market. These models differ in size, colour, weight of the components and are manufactured to cater to different market segments of the bicycle market. Each large cycle manufacturer makes at least 20 different models. But more than 70% of the demand is for the standard roadster model of the bicycle. Thus, the cost analysis of a standard roadster model can be of great assistance to an AO. The attempt at providing the cost analysis of the different components is only an approximation and it applies to the standard roadster model of the bicycle. This Cost analysis should be considered indicative and cannot be applied ipso facto to any particular company. In other words, it is an average and indicative analysis of the cost of different components for general guidance of the AOs to cross-verify whether a manufacturer is booking excessive cost with respect to specific components. This analysis would be useful in cases where the bicycle manufacturer purchases some components from concerns in which its directors/ partners have substantial interest.

6. Standard Input-Output Norms for Different Parts of a Bicycle: Exact input-output norms for different parts of a cycle are not available. The exercise involved is complex in view of the large number of models of cycles available in the market. But from an investigator's point of view, the input-output norms provide a useful tool to verify the raw material cost debited by the manufacturing units in the books of accounts. Ministry of Commerce, Government of India, periodically conducts input-output surveys of different parts of a cycle. Information so generated is used for various duty exemptions available to the cycle industry. These norms also take into account the likely wastage in manufacturing different parts of a cycle. If in a particular case, it is found that the raw material used for a particular component is much more than given in norms or is shown of a quality and nature different than that in these norms, then the AO must check the purchases of the raw material and its utilization to manufacture different components of a cycle.

7. OTHER POINTS FOR INVESTIGATION

7.1 Cycle components require a high degree of standardization and the norms of variation from any given standard are provided in any contract entered into by a cycle manufacturer with the ancillary units. Normally, an ancillary contract is accompanied by detailed drawings of the component to be manufacturer specifying the weight of the component, and the degree of variation permitted in weight or machining of that component. This primary record is of vital importance to investigate the raw material requirement for manufacturing the components or parts by the ancillary units. If the AO finds that the raw material debited by the ancillary units is of different quality than that given in the contract or the quantity debited by the ancillary unit is much more than warranted by the detailed drawing of the component and the standard input-output norms of the component, then this information can be a good starting point for detailed inquiry to determine excess raw material cost debited or to establish that the ancillary unit is showing less production and Sales in the books of accounts as compared to actual production.

7.2 The AO must keep up-to-date with the new techniques of production becoming available in this industry. With increase in competition manufacturers are striving to reduce wastage of raw material and to recycle the waste generated.

What was once considered waste material and sold as scrap, is finding new buyers and users. For instance, in the manufacturing of chain wheel, the HR sheet or coil cut by press to make holes in it, was being sold as scrap and waste. But lately, this scrap is being used to manufacture metallic washers for the automobile industry. Similarly, the bonding of lugs and tubes used in the frame sub-assembly of the bicycle was traditionally done by using brass. But with improvement in technology, brass is no longer required for bonding and consequently the raw material cost of frame sub-assembly has come down.

7.3 The AO must look into the nature of plant and machinery and the likely decline in labour and production cost as a consequence of addition to new machinery. In most of the units, for instance, frame assembly is a labour intensive process. It involves the heating of the frame and tubes and lugs in furnace. A frame assembly team in this method of production consists of six to eight labourers. With the installation of robotic assembly of frames, the same task is performed by one trained person. Thus with the introduction of one such robotic frame assembly unit, the labour requirement and cost for assembling the frame declines to say one-sixth to one-eighth of the original cost. Same is the case with the fixing of spokes in the wheel rim. The labour working on mechanised wheel spoke fitting apparatus are three to four times more efficient than the traditional manual wheel spoke fitters. Therefore, the importance of linking the installation of new machinery with decline in some of the production cost is an aspect which must be looked into by the AO.

7.4 Another point which needs to be noted is that there are no exclusive or captive ancillary units in this industry. Typically the ancillary units provide components and parts to two to three manufacturers. There is a large informal market for replacement of components and parts. Thus, these ancillary units have access to an extensive network of repair shops and a ready market exists for the components manufactured by them. This segment is largely in informal and unstructured sector and is the likely channel through which unrecorded production of components manufactured by these ancillaries are sold.

7.5 The AO assessing the cases of the directors or partners of large cycle manufacturers must remember that these persons exercise great control over the small ancillaries which supply components to these concerns. The profitability, and in most of the cases the very existence of these ancillary units, depends on the orders received from the big units. Given the unequal power of the two players in this arrangement, the issue of pay-offs to these individuals at the time of granting ancillary contract has to be kept in mind. Evidence of this nature must be looked for during any survey or search in these cases.

7.6 A recent trend in this industry has also been to import readymade cycles from China and other South East Asian countries, and to sell these under local brand names after stamping of local trademarks. Such an activity will normally not constitute as production of an article or thing.

8. CONCLUSION

The bicycle industry had remained stagnant for a long time, but the winds are changing now, a lot is happening in the industry and in the country, due to which the market is set to grow in the future. The efforts made by manufacturers to grab the market through interventions like entering into joint ventures with foreign brands, revisions in the marketing and distribution strategies, introduction of wider product portfolio and innovations like carbon frames, etc. have impacted the market positively. On the other hand, the lifestyle changes in the society and inclination towards premiumization in bicycles have also contributed to changed outlook towards bicycles. The AO would, therefore, have to consider the issues of globalization, changing technological, economic as well as market scenarios while carrying out investigation and assessment of the accounts of the assesses in this sector.

CHAPTER

11

Power and Energy

1. POWER SECTOR: BACKGROUND AND GENERAL INFORMATION

Sector in Brief: Power is one of the crucial elements of infrastructure and in the context of a growing economy like India, even more so. India is the third largest producer and the fourth largest consumer of electricity in the world. It also has the fifth largest installed capacity in the world. The installed capacity is also one of the most diversified with sources of power extending from thermal to hydro to nuclear to wind to solar to several other renewable sources. The power generation sector is also quite evenly distributed with the public as well as private sectors making substantial contributions.

2. KEY CHARACTERISTIC OF POWER PROJECTS IN INDIA

a. Long Gestation Period

b. Capital Intensive

c. Highly leveraged

d. Technology driven

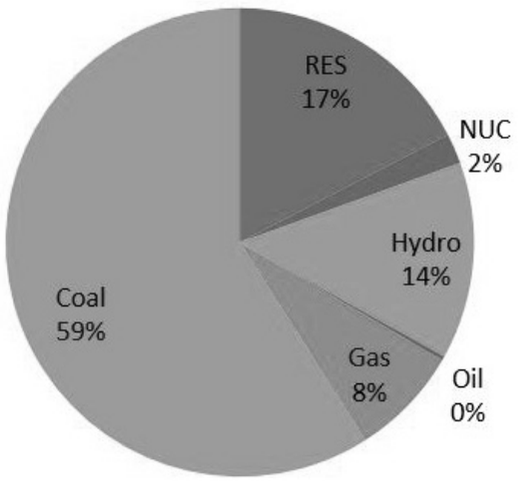
e. Regulatory Issues

f. Reduced entry barrier to promote private sector participation

g. Coal fired generation dominates the generation portfolio

3. SHARE OF VARIOUS ENERGY SOURCES IN TOTAL INSTALLED CAPACITY

TOTAL CAPACITY: 329.3 GW (as on 30 June 2017)



Source: Ministry of Power

4. THE MAJOR PLAYERS—A COMPETITIVE MIX OF PUBLIC AND PRIVATE SECTOR

4.1 The total installed power generation capacity in India stands at 329.3 GW (as on 30 June, 2017). The share of the private sector stands at 43.6%, while the State and Centre hold 31.5% and 24.7% share respectively. Although the majority share of the installed capacity belongs to the state-owned utilities such as NTPC, IPPs are fast catching up. In the Eleventh FYP, the private sector achieved 117.5% of its target by contributing 23.0 GW to the overall capacity. It was far ahead of the State and Centre in terms of achieving the targeted capacity addition in the period. The private sector added 54.3 GW of capacity in the Twelfth FYP achieving 115.9% of its target. The Centre and the State achieved 78.1% (20.4 GW) and 157.6% (24.4 GW) of the target, respectively.

4.2 State owned **NTPC** is the largest generating utility in the country, with installed capacity of 51,635 MW (including 7216 MW through JVs/ Subsidiaries) comprising of 48 NTPC Stations (20 Coal based stations, 7 combined cycle gas/ liquid fuel based stations, 1 Hydro based station), 9 Joint Venture stations (8 coal based and one gas based) and 12 renewable energy projects. By 2032, NTPC plans to reach 128,000 MW of power capacity.

4.3 Tata Power is India's largest integrated power company, with significant presence in solar, hydro, wind and geothermal energy space. The company accounts for around 52% of total generation capacity in the private sector. The company has an installed capacity of 1.0 GW in FY 17. By 2022, the company plans to increase the generating capacity to 18GW, distribution networks by 4 GW and energy resources by 25 million tonnes per annum.

4.4 Adani Power is one of India's largest private thermal power producers, with total capacity at 10.4 GW in 2016; the company aims to generate 20GW of power by 2020. The company is one of the world's largest single location thermal power plants in Mundra, Gujarat.

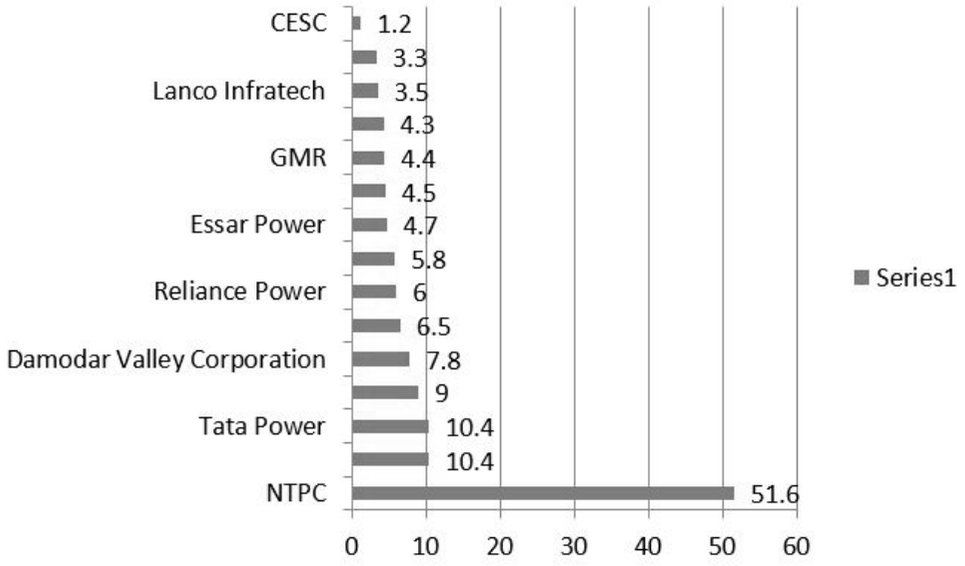
4.5 NHPC is the largest hydro power utility in India with an installed capacity of 6.5 GW: It is has drawn up a massive capacity expansion plan of adding 6.7 GW by 2017 NHPC is constructing 9 projects aggregating an installed capacity of 4.2 GW.

5. NEW REGULATIONS—BOOSTING COMPETITION IN THE SECTOR

5.1 The utilities landscape has been evolving with the introduction of new regulations that have enhanced competition. As per the guidelines released by the Central Electricity Regulatory Commission (CERC), post-tax return on equity has been maintained at 15.5%, but the incentive structure has been linked to actual generation beyond the threshold level of 85%. These have been framed to ensure that the end consumer benefits from higher efficiency in the system. The guidelines are expected to reduce the profitability of state owned utilities. CERC made it mandatory for state owned utilities such as NTPC and NHPC to competitively bid for projects after January 2011. Previously, state-owned utilities ensured offtake through MoUs and were entitled to tariff based on the cost-plus mechanism. Competitive bidding would benefit end customers in the form of reduced tariffs.

5.2 In order to ensure growth of hydro power generation, Govt. approved hydro projects exemption from competitive bidding through August 2022 and they will be awarded under cost-plus basis. Since the cost of generating hydro power is higher than that for thermal power, the absence of cost-plus tariff would have been posed challenges to the hydro power offtake.

6. MAJOR PLAYERS IN THE SECTOR AS ON 31ST MARCH 2017 (AS PER OPERATIONAL INSTALLED CAPACITY IN GW)



Source: Company annual report, company websites

7. KEY TRENDS

7.1 Accelerated Capacity Addition: Over the years, the Government increased focus on accelerating the rate of power capacity addition. Historically, the Indian power sector has underperformed in terms of capacity addition, missing the targets of various FYPs by close to 50%. However, the performance of the sector in the eleventh FYP was relatively better, having realized close to 88% of the targeted capacity addition the targets was overachieved in the Twelfth FYP, with 112% of the targeted capacity addition. Although Government–owned utilities dominate the current installed capacity, private sector led the capacity addition in the Eleventh and Twelfth FYP, contributing 42% and 54.7% share respectively.

7.1.1 While the GoI is attempting to reduce the demand supply gap by increasing the rate of capacity addition, there is a need to simultaneously address other concerns such as emissions from thermal power plants and adequate fuel supply availability.

7.2 Increasing Role of the Private Sector and Ongoing Consolidation in the Industry: The private sector owned around 43.6% of the total installed capacity in June, 2017. Installed generation capacity owned by the private sector increased from 7GW in March 2002 to 143 GW in June 2017. The sector exceeded its targets by 17.5% in the Eleventh FYP vis-a-vis achievement of only 27.1% of the target in the Tenth FYP. (The sector exceeded its target by 15.9% for the Twelfth FYP). The major players in the power sector are acquiring power projects with fuel linkages, power purchase agreements and land acquisition approvals in place–thus acquiring at a reasonable valuation, projects which have overcome the regulatory bottlenecks.

7.3 Nuclear Power Generation Gaining Prominence: India has shown significant interest in expanding it domestic nuclear sector, as a means to meet rapidly growing demand for electricity, lower emissions through the adoption of low carbon power sources and capitalize on its indigenous reserves of uranium and thorium. The government plans to source 25% of the country's

electricity from nuclear energy by 2050, up from the current level of 2.5% and the project pipeline has strengthened in line with these targets.

7.4 Shift Toward Advanced/ Efficient Technologies to Ensure Availability of Reasonably Priced Power: There is a clear shift in the market towards large unit sixed and supercritical technology (SCT). Leading players in the power sector are moving toward superior technologies for enhanced efficiency. Furthermore, NTPC and state utilities lined up several projects based on SCT during the Twelfth FYP. SCT is expected to provide reasonably priced power due to its efficient coal burning mechanism, which provides 3% to 4% more power on a unit of coal as compared to that provided by other existing technologies.

7.5 Regulatory Impetus to Renewables: Growing demand for energy, technological advancement, depleting fossil fuel reserves and concerns around global warming are driving the development and use of renewable sources for power generation. Government incentives such as tax rebates/ holidays, duty cuts, interest and capital subsidy, and soft loans have encouraged the development of renewable energy. As on 30 June, 2017, domestic renewable energy generation capacity stood at 101.86 GW accounting for 31% of total generation. According to power ministry estimate, another 8.8 GW capacity is likely to be added in 2017, including about 1.1 GW of rooftop solar installations.

7.6 Emerging Opportunities in the R&M Space: Power equipment manufacturers have an attractive opportunity in the renovation and modernisation (R&M) of the ageing thermal generation fleet. Strong traction is foreseen in up-rating, renovation and modernisation, with more than 30GW of installed thermal capacities, currently over the age of 25 years.

7.7 Smart Metering to Reduce AT & D Losses of Wrong Billing: The smart meter installed base in India could rise by a large number with the government mandating all meters within monthly consumption range of 200–500 units to be converted into smart meters by 2019 and all meters with monthly consumption above 500 units to be converted into smart meters by 2017 end. Smart meters can reduce AT & D losses and improper billing.

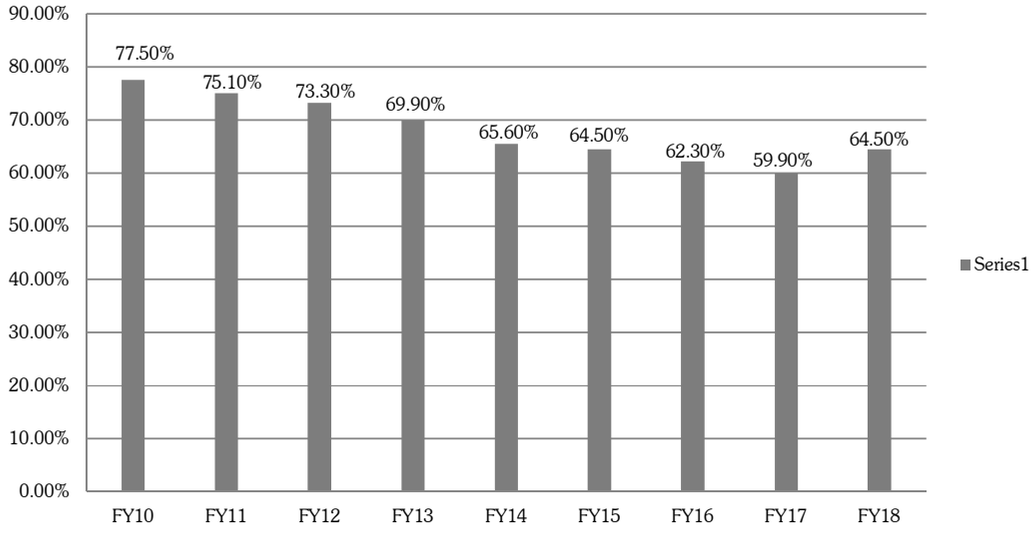
7.8 Use of Digital Technology, Automation and Analytics: Internet of Things, together with Big Data and Analytics can help reduce India's power losses, thereby providing electricity to millions of households that go without power every day. Smart Grids with automation, integrated controls and new technologies such as connected sensors can held in faster restoration of electricity after outages, efficient power transmission, reduced management expenses and integration of energy systems that are based on green and renewable sources of energy like wind and solar energy. This would thus help in managing energy while reducing dependency on non-renewable sources. The recent investment decisions taken by GoI highlight the positive intent to adopt the latest and advanced technologies.

8. KEY CHALLENGES

8.1 Demand Supply Mismatch for Power: Substantial addition in generation & transmission capacity and widespread adoption of energy efficient measures has played a major role in augmenting supply of electricity. However, the tepid industrial growth demand growth has result in weak electricity demand resulting into declining trend of Plant Load Factor (PLF) indicating an under-utilisation of the existing capacity.

8.2 Decreasing Utilisation of Installed Capacity: The PLF of thermal power stations is an index of utilisation of the installed capacity. The average PLF has been on a constant decline from 77.5% in FY 10 to 59.9% in FY 17. CERC norms provides incentives to the generation and distribution companies based on their PLF. Lower PLF will lead to lower incentives and will have an impact on power unit margins.

Exhibit 7: Plant load factor for coal and lignite based plants



Source: Ministry of Power

8.3 Raising Price of Inputs Notably of Coal: The increase in clean energy cess from INR 200 per ton in FY 16 to INR 400 per ton in FY 17 is likely to increase the cost of coal by INR 200 per ton and will also raise the cost of production by 14–15 paisa per ton. This surge in the cost of electricity will be further passed to consumers.

8.4 Delay in Project Commissioning: Archaic land acquisition rules, frequent strike, slow civil work, contractual dispute and delays in obtaining procedural clearances have impacted the achievement of targeted capacity addition in previous plans. During 12th FYP, difficulty in obtaining environmental approvals and land clearances resulted in significant slippage to the planned (88,537MW) capacity additions targets. As per 6th Draft National Electricity Plan, the estimated slipped stands at 21386 MW which is 24% of the target capacity addition. Private sector share in this slippage capacity accounts for almost 54% share during 12th FYP. Delay in timely completion of power projects has resulted in cost and time overrun affecting the overall all financial health of entities undertaking these projects.

8.5 Effect of India's Signing of Paris Agreement—Conscious Attempts to Reduce Carbon Emissions: India is the third largest CO_2 emitter in the world behind china and the United States. However, the country has recently taken important steps to curb coal use for natural gas and renewable energy sources. A few years ago, the country had been on the path to triple their coal-fired electricity generation by 2020 However, singing of the Paris agreement and the significant drop in renewable energy prices has led to a dramatic shift in strategy. As part of the Paris Agreement, India has committed to 40% of Indi's electricity capacity to come from renewable sources by 2030.

8.5.1 Another issue for several thermal projects that registered with the Clean Development Mechanism scheme for Renewable Energy Certificate (REC) trading, was the collapse in carbon prices after the global recession. (*Renewable Energy Certificates (REC's) also known as 'Green Tags' or tradeable Renewable Energy Credits (TRC's) are tradeable, non-tangible energy commodities that represent the fact that 1 megawatt-hour (MWh) of electricity was generated from a renewable energy sources and was fed into shared systems of power lines that transport electricity. These certificates can be sold, trade or*

bartered). This reduced a once-anticipated revenue stream in the form of REC trading/ selling for utilities.

8.6 Advent of Solar Rooftops: India's electricity production per kilowatt solar installation is the highest compared to any other country in the world. This is because of India's geographical location on account of which it receives abundant tropical sunshine. Rooftop Solar panel does not require high initial investment which allows ordinary households to generate their own electricity with government subsidy and intense competition making them cheaper. The rise of "Prosumer" can threaten the very existence of thermal power plants that already struggle with decreasing PLF and sluggish demand.

9. THE WAY FORWARD

9.1 With capacity growing faster than the demand, India is likely to emerge as a power surplus nation. Electricity consumption is essential to support economic growth. With this understanding, power industry in the past has witnessed significant capacity addition across fuels (particularly in coal-fired thermal power plants) and transmission segment.

9.2 Recently, with aggressive targets, the Government placed special focus on the development of clean and sustainable energy, Wind Power and solar power are emerging as important sources of sustainable clean energy. The outlook for the sector is optimistic, with policy thrust by the government and the rising maturity/ reducing cost of technology. Factors such as a smaller gestation period, attractive feed-in tariffs, clean development mechanism credits and renewable purchase obligations on distribution licenses are likely to continue driving renewable energy.

9.3 Moody's Investors Service and its Indian affiliate, ICRA limited, upgraded the outlook for the Indian power sector to "stable" over the next 12–18 months in June 2017 with a Baa3 positive rating reflects sustained improvement in domestic coal availability, as well as the Indian government's policy initiatives, which will likely lead to improvements in the financial position of state-owned electricity distribution companies in the next two to three years.

9.4 The recent approval of a particular coal linkages policy will address the challenges associated with coal availability and is likely to bring down the overall generation cost.

9.5 With such robust measures in place, the supply side dynamic of the power sector is set to improve. As for the demand side, a major overhaul is required to ensure that a substantial amount of demand growth continues to support the absorption of large scale capacity addition that is expected to get commissioned in the next five years.

10. POWER DISTRIBUTION

The Indian power sector has historically been dominated by the long term power market. State utilities/ distribution licensees (discoms) are the bulk purchasers of electricity, since they have an obligation to supply electricity to the consumers. Most of the bulk supplies are through long term power purchase agreements (PPAs) with state generating companies, central generating companies and independent power producers (IPPs) etc. Of the total electricity generated in India in 2015–16, around 90% was procured by distribution companies through long term contracts and short term intra-state transactions.

11. CHALLENGES SPECIFIC TO THE POWER MARKET

Due to the dynamic nature of the demand supply situation, long term contracts are not able to meet the full requirements of buyers in the national market. This is because of the following challenges related to the power market:

a. Electricity as a commodity cannot be stored.

b. Hourly consumption of power over a long term without forecasting errors is difficult to predict.

c. Long term contracts opf peak load requirement are economically inefficient.

Hence, development of a short term trading market to complement the long term trades that cater to the core demand is very important for efficient working of the power sector.

12. SHORT TERM POWER MARKET

12.1 The short term power market in India cover contracts of less than one year period for electricity supply. This includes electricity transacted under:

a. Bilateral transactions through inter-state trading licensees (only interstate part)

b. Power exchanges (Indian Energy Exchange Ltd.(IEX) and Power Exchange India Ltd. (PXIL)

c. Deviation settlement mechanism (DSM) i.e. uninterrupted interchange (UI) transactions

d. Transactions directly between DISCOMS

12.2 Volume of short-term transactions with respect to total electricity generation:

Year	Total Volume of Short-term Transactions of Electricity (BU)	Total Electricity Generation (BU)	Short-term Transactions of Electricity as Percentage of Total Generation
2009–10	65.90	764.03	9%
2010–11	81.56	809.45	10%
2011–12	94.51	874.17	11%
2012–13	98.94	907.49	11%
2013–14	104.64	962.90	11%
2014–15	98.99	1048.67	9%
2015–16	115.23	1107.82	10%

12.3 Volume of short-term transactions of electricity (BU)

Year	Transacted through trading licenses	Transacted through power exchanges	UI transactions	Transactions directly between discoms	Total transactions
2009–10	26.72	7.19	25.81	6.19	65.90
2010–11	27.70	15.52	28.08	10.25	81.56
2011–12	35.84	15.54	27.76	15.37	94.51
2012–13	36.12	23.54	24.76	14.52	98.94
2013–14	35.11	30.67	21.48	17.38	104.64
2014–15	34.56	29.40	19.45	15.58	98.99
2015–16	35.43	35.01	20.75	24.04	115.23

12.4 Perusal of the above tables reveal that the percentage of power traded remains fixed at around 9–10% whereas the absolute volumes have risen.

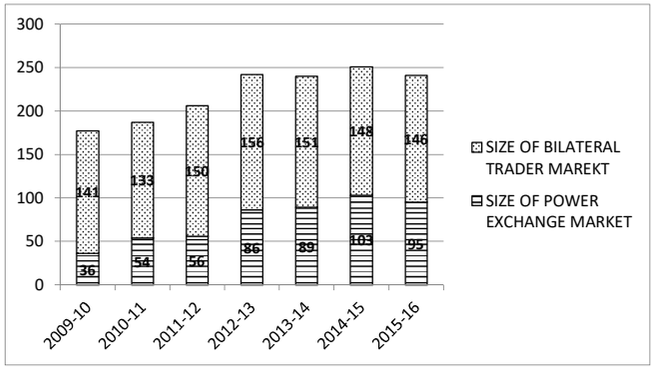
13. VOLUME OF ELECTRICITY TRANSACTED THROUGH TRADERS AND POWER CHANGES

Year	Electricity Transacted through traders (Bus) (A)	Electricity Transacted through IEX (Bus)		Electricity Transacted through PXIL (Bus)		Electricity Transacted through IEX and PXIL (Bus) (B)
		Day Ahead Market	Term Ahead Market	Day Ahead Market	Term Ahead Market	
2008–09	21.92	2.62		0.15		2.77
2009–10	26.72	6.17	0.10	0.92	0.003	7.19
2010–11	27.70	11.80	0.91	1.74	1.07	15.52
2011–12	35.84	13.79	0.62	1.03	0.11	15.54
2012–13	36.12	22.35	0.48	0.68	0.04	23.54
2013–14	35.11	28.92	0.34	1.11	0.30	30.67
2014–15	34.56	28.12	0.22	0.34	0.72	29.40
2015–16	35.43	33.96	0.33	0.14	0.58	35.01

Note: The volume of electricity transacted through traders in 2008–09 (April to July 2008) includes-cross border trading and trading volume.

14. MARKET SIZE

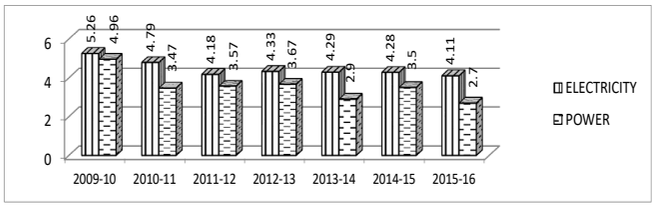
Size of the bilateral trader and power exchange market (INR billion)



Source: CERC

15. PRICING TRENDS

Price of electricity transacted through traders and power exchanges.



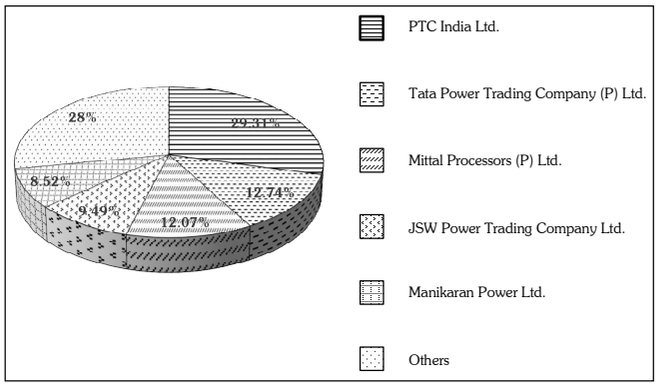
Price of electricity transacted through traders(INR/ kWh)
Price of electricity transacted through power exchanges (DAM + TAM)(INR/ kWh)

As is apparent from the bar graph above there is a substantial difference in the price of electricity transacted between traders vis-a-vis power exchanges.

16. MAJOR PLAYERS IN THE INDIAN POWER MARKET TRANSACTIONS

PTC India Ltd. leads the market for execution of short-term power market transactions in India with 29% of the total market share. Other leading traders include **Tata Power Trading** (12%), **Mittal Processors** (12%), **JSW Power Trading** (9%) and **Manikaran Power** (8%). The top seven traders together account for 83% of the total electricity transacted by traders. The weighted average trading margin charged by trading licensees in 2015–16 was 0.03 INR/ kWh, which is in line with the CERC Trading Margin Regulations, 2010.

Percentage share of electricity transacted by traders, 2015–16



Share of Electricity Transacted by Traders, 2015–16

17. KEY CHALLENGES IN THE POWER DISTRIBUTION SECTOR IN INDIA

17.1 Poor Financial Health of Discoms: Although several states have raised tariffs in recent years, financial condition of most discoms remains under stress. As a result, most state discoms shy away from buying costly power from exchanges and prefer to opt for load shedding instead. Moreover, poor financial condition of discoms is putting power traders at risk. Currently, traders are supplying power without any payment security mechanism and without a choice to terminate a contract, in case of a payment default.

17.2 High Competition Resulting in Reduced Trading Margins: The competition in the power trading Industry has increased with issuance of multiple trading licenses by CERC. This increasing competition has put considerable

downward pressure on trading margins, which has forced some companies to either surrender their licenses or wilfully default in fee payments, leading to license revocation by the regulator.

17.3 Transmission Constraints: Power trading is also affected by continued corridor constraints for power flow. Adding to the chronic woe of transmission corridor congestion from NEW grid to Southern grid, some other crucial regional interlinks have started facing congestion issues. Congestion has also arisen in flow of power from the western region (region with highest merchant generation) to northern region (region with maximum demand.)

17.4 Fuel Price Risk: Discoms have an obligation for competitive bidding through case I or Case II route for power procurement. However, since the sellers are unwilling to take fuel price risks and prefer this risk to be built into the tariffs, procurement by discoms through case I or Case II route has been below the desired levels.

17.5 Lack of Regulatory Clarity for Trading of Imported Power: The Government of India has shifted the subject of import of power from "restricted" category to "free" category. However, there is limited regulatory clarity with regards to sale of imported power through power exchanges, which is posing difficulties for power importers. Considering that India is envisaging to import large quantum of power from neighboring countries, setting up of an appropriate regulatory framework for trading of imported power will be very important.

17.6 Traders not Allowed to Participate in Case-1* Bidding: The Ministry of Power has revised the norms under which discoms purchase power on long-term and medium-term basis. Under these revised norms, power traders are not allowed to participate in case-1 bidding, thereby limiting their business opportunities.

***** (*Case-1 bids are those where the quantum, time period of power procurement is known but fuel type, source of location plant is not specified.*)

17.7 Restrictions on Fuel (Coal) Availability: Thermal capacity addition is restricted by the growing fuel availability concerns. Coal supplies by CIL is restricted to around 65% of actual coal requirement by coal based thermal plants, leading to increased dependence on imported coal that results in high power generation costs. However, this situation is easing up as Indian Government has taken steps to increase coal production.

17.8 Equipment Shortage: the shortage in primarily in the core components of Boilers, Turbines and Generators. Also, there has been lack of adequate supply of Balance of Plant (BOP) equipment as well. These include primarily coal-handling and ash-handling plants.

17.9 Delayed Land Acquisition and Environment Clearance: Power plants and utilities face major constraints and delays regarding the availability of land and obtaining the requisite environment and other clearance for the projects.

18. DISCUSSION ON TAXATION ISSUES

18.1 Given the relatively complex nature of the power generation and distribution sector in India, as explained above, the taxation of the same results in challenges on various issues like rates of purchase of raw material, applicable and allowable deductions, depreciation claims, taxation of subsidies extended to this sector, issues relating to sale and lease back of power assets, issues related to renewable energies, quantification of transmission and distribution losses, applicability of minimum alternate taxation (MAT) to such power generation and transmission units, international taxation issues and transfer pricing issues. These issues are elaborated in some detail below:

18.2 Investigation of Raw Material Cost

a. Gross Calorific Value of Coal

b. Boiler efficiency

c. Plant Load factor

18.3 Issues Related to 80IA

a. Background

b. Debate of "setup" and "begin to generate"

c. Profits" derived from" 80IA

d. Transfer Pricing and shifting of expenses/ profits

18.4 Taxability of Subsidies

18.5 Issues Related to Sale and Lease Back of Assets

a. New developments

b. Depreciation claims

c. Checklist for genuineness of the agreements

d. Dispute in the rates of TDS

18.6 Issues Related to Renewable Energy

a. Depreciation claims on wind mills

b. Taxability of Carbon credits

18.7 Transmission and Distribution Losses

a. Genuineness

b. Quantification

18.8 Issue Related to Applicability of MAT: Exceptions to Schedule VI in the Companies Act

18.9 International Taxation Issues

a. Severance of Supply of equipment and Services in EPC/ Turnkey contracts

b. Non deduction of TDS

c. Other International taxation issues

18.10 Transfer Pricing Issues

a. Purchase of coal from AEs

b. Loan transactions

c. Corporate Guarantee

d. Inter-unit transfer between exempted and non-exempted unit

19. INFLATION OF CONSUMPTION OF RAW MATERIAL

19.1 Showing receipt of below par material i.e., coal with less thermal efficiency, high Sulphur content and high ash content. Due to this, the consumption of the coal may be inflated and, thereby, the profits are reduced. In order to investigate this, the AO should call for the details of the boiler/ plant capacity, the Plant Load Factor (PLF) and the boiler efficiency specifications. This then needs to be co-related to the quantity of the coal claimed to be consumed to produce the amount of power disclosed in its books. As the production figures are difficult to fudge, the boiler efficiency multiple may be used to calculate the input tonnage of coal which would have been consumed to produce the claimed quantum of power. While calculating the tonnage of coal, due consideration should be given to the Gross Calorific Value (GCV) of the coal which is being used. Higher the GCV of coal, the higher the heat produced per unit and hence, higher is the cost price of coal.

19.2 Another *modus operandi* is showing receipt of lesser coal from rail wagons or the trucks than shown in purchase bills. This is followed by lengthy procedure of filing claims with the railways and coal companies that are seldom settled. In order to investigate this, the primary record regarding the quantity/ quality

testing of the raw material at the time of receipt; and the receipt register along with the weigh bills of the trucks may be called for examination.

20. APPLICABILITY OF SECTION 80IA

20.1 Background of Deduction *u/s* 80IA of the Act: Section 80IA of the Income-tax Act, 1961 provides for a deduction in respect of the profits and gains from industrial undertakings or enterprises engaged in infrastructure development. The power generation and transmission sector falls under the purview of infrastructure development. The deduction envisages an amount equal to 100% of the profits and gains derived from such business for 10 consecutive assessment years. The deduction is also available in case the enterprise/ undertaking undertakes substantial renovation and modernization of the existing transmission or distribution lines. The deduction can be claimed at the option of the assessee for any 10 consecutive assessment years out of 15 years beginning from the year in which the undertaking or the enterprise begins to generate power or commences transmission or distribution of power or undertakes substantial renovation and modernization of the existing transmission or distribution lines. There are various conditions laid down regarding the organisation and commencement of the undertaking which need to be complied with and also certain time lines have been laid down prescribing the period when such activity should be commenced, for availing of the deduction.

20.1.1 Tax Holiday—Section 80IA(4) (iv): The specific Section dealing with power generation and transmission companies is Section 80IA(4)(iv) of the Income-tax Act, 1961. The conditions to be fulfilled to claim the benefit are as follows:

Particulars of the Undertaking	Specified Period of Operations	Exclusions/ Explanation if Any
It is setup in any part of India for the generation or generation and distribution of power	1.4.1993 to 31.3.2017	
It starts transmission or distribution by laying a network of new transmission or distribution lines	1.4.1999 to 31.3.2017	The deduction in this case shall be allowed only in relation to the profits derived from laying of such network of new lines for transmission or distribution
It undertakes substantial renovation and modernisation of the existing transmission or distribution lines	1.4.2004 to 31.3.2017	"Substantial renovation and modernisation" shall mean an increase of plant and machinery by at least 50% of the book value of such plant and machinery as on 1.4.2004."

In addition to above, conditions *u/s*. 80IA(3) also need to be fulfilled to claim the benefit.

20.2 Debate of "Setup" and "Begin to Generate": Deduction *u/s* 80IA of the Act is allowable in respect of profits and gains derived from any business of an industrial undertaking or enterprise engaged in infrastructure development, etc. A close perusal of the wording of the relevant Section of the Income-tax Act, reveals that the deduction is eligible for an undertaking which is 'set up' in any part of India for the generation/ distribution of power, if it begins to generate power at any time between 1st April 1993 and 31st March 2017. As discussed earlier, power generation projects are capital intensive and typically involve long gestation periods. In such circumstances, disputes may arise between

the assessee and the Tax Authorities on when exactly an undertaking was 'set up'. This is a contentious issue which needs to be resolved on a case-to-case basis taking into consideration the factual matrix of each case. The assessing officer may obtain documents relating to test runs conducted by the undertaking before it begins to generate the power.

20.3 Meaning of Connotation "Profits Derived from": The Hon'ble Supreme Court in the case of *CIT vs. Sterling Foods* [237 ITR 579] has held that for the application of the words "derived from" used in Section 80HH, there must be a "direct nexus" between the profit and the industrial undertaking. It was further held that profits out of sale of import entitlements cannot be said to be profits "derived from" the industrial undertaking. This decision may be kept in view while examining claims for deductions *u/s* 80IA of the Act. Some important decisions, which may also be referred to in this regard are Pandian Chemicals 262 ITR 278 (SC) and *M/s. Liberty India* (2009) 317 ITR 218 (SC).

20.4 Determination of First/ Initial year of Claim of 80IA: Due care should be given to the determination of the correct initial year in which the claim of deduction under Section 80IA would start. This determination may be prone to manipulation by some assessees. Since the provisions of tax holiday *u/s*. 80 IA(4)(iv), now has sunset Clause in the sense that the deduction will not be available for the undertakings setup beyond the period of 31.03.2017. In view of this, the Assessing Officer should be vigilant in examining the claim where the assessee claims that, (a) it has setup undertaking for generation or generation and distribution of power, (b) it started transmission or distributions by laying a network of new transmission or distribution lines, (c) it has undertaken substantial renovation and modernization of existing transmission or distribution lines upto 31.03.2017. The cases where tax payers have claimed setting up of industrial undertaking in the later period of F.Y. 2016–17, a detailed examination of fulfilment of condition relating to setting up of the undertaking, may be carried out before allowing the deduction.

21. Taxation of Receipt of Subsidies in the Sector: To attract foreign investors, the government has taken several initiatives such as introducing GBI (Generation Based Incentives) schemes to promote projects under Independent Power Producers (IPP) mode for wind and solar power.

21.1 In the case of *CIT vs. Ponni Sugars and Chemicals Limited* 306/ TR 392 (SC), the Hon'ble Supreme Court held that the character of receipt in the hands of assessee has to be determined with respect to the purpose for which subsidy is given. In other words, the, "Purpose test" is to be applied. The point of time when the subsidy is paid is not relevant. The source is immaterial. The form of subsidy is also immaterial. In this *case*, eligibility condition in the scheme was that incentive must be Utilised for repayment of loans taken by the assessee for setting up of a new unit or substantial expansion of the unit. While explaining the principle, the Hon'ble Court also observed that if the object of the subsidy scheme was to enable the assessee to run the business more profitably, then the receipt would be on revenue account. It further explained that on the other hand, if the object of assistance under the subsidy scheme was to enable the assessee to setup a new unit or to expand its existing units, then the receipt of subsidy was on capital account.

21.2 In another landmark case of *Sahny Steel and Press Works Limited vs. CIT* 228 ITR 253 (SC), the Hon'ble Supreme Court analysed the Scheme of subsidy granted by the Government of Andhra Pradesh. According to the notification, certain facilities and incentives were to be given to all the new industrial undertaking which commenced production on or after 01.01.1969 within investment capital not exceeding Rs. 5 crores. The incentives were to be allowed for a period of 5 years from the date of commencement of production. The incentives were not available unless and until production had commenced.

21.3 Another important judgment laying down the principles was in the case of *CIT vs. P.J. Chemicals* 210 ITR 830 (SC). Hon'ble Court applied purpose test. The Court held that measure of subsidy was not relevant in determining the character. In this case, ITO was of the opinion that statutory concept of actual cost in Section 43(1) compelled deduction of central subsidy received by the assessee. The Hon'ble Court held that the govt. subsidy, in that case was an incentive not for the specific purpose of meeting a portion of the cost of assets, though quantified as or geared to a percentage of such costs. If that be so, it does not partake the character of payment intended directly or indirectly to meet the actual cost.

21.4 ITAT, Pune in rulings rendered in December 2017, in the case of *Indo Enterprises Pvt. Ltd.* [ITA No.1362/ Pun/ 2011 and ITA No. 2389/ Pun/ 2012] and Patankar Wind Farms has discussed the issue of tax treatment of subsidy in detail while adjudicating the nature and character of Sales Tax subsidy received by the assessee on generation of power through wind mill, under the scheme of state government. The judgment referred to a number of case laws on the subject while discussing the issue. It was held that the Sales Tax subsidy under the said scheme was revenue in nature.

21.5 Hon'ble Delhi High Court in the case of *CIT vs. Bhushan Steel & Strips Ltd.* (2017) [83 taxmann.com 204 (Del.)] reversed the ITAT's rulings for A.Y. 1995–96 after analysis of Sales Tax subsidy Schemes. The Hon'ble High Court held Sales Tax Subsidy to be a revenue receipt absent capital utilization condition. High Court approved revenue's reliance on Supreme Court's ruling in *Sahny Steel (*supra*)* wherein the Court was persuaded to hold that the amount represented revenue receipt and not capital because the payments were made only when assessee commenced its production. The Hon'ble High Court noted that '*This subsidy scheme had no strings attached. It merely stated that the collection could be retained to the extent of 100% of capital expenditure. Whilst it might be tempting to read the linkage with capital expenditure as not only applying to the limit, but also implying an underlying intention that the capital expenditure would thereby be recouped, the absence of any such condition should restrain the Court from so concluding.'*

21.6 The attention of the assessing officer is invited to provisions of Explanation 10 below, Section 43(1) relating to actual cost.

21.7 Amendment in Section 43(1) of the I.T. Act, 1961: At the same time, the Government through appropriate legislation has sought to balance larger concerns like black money/ unaccounted income with allowance of deductions to undertakings operating in social sectors. An example is the recent amendment to Section 43(1) of the Income-tax Act, 1961 which comes into effect from 01-04-2018, providing that where an assessee incurs any expenditure for acquisition of an asset or part thereof, and payments made for the same exceeding Rs. 10,000/- in a day is made other than by an account payee cheque or electronic clearing, such excess expenditure shall be ignored for purposes of determination of actual costs.

22. SALE AND LEASE BACK OF ASSETS

22.1 New Developments and Depreciation Claims: The Government of India has come up with numerous policy initiatives to control the pollution caused by the coal based thermal power plants. To measure the extent of polluting gases and the particulate matter, Air Quality Index benchmarks have been formulated. The Central Pollution Control Board (CPCB) has also issued directions to Thermal Power Plants to ensure new norms on Sulphur Dioxide emission limits in coal fired power units be implemented in a phased implementation plan by the installation of Flue Gas De-Sulphurization (FGD) and other emission control equipment. Based on the

discussions with Ministry of Environment, Forest and Climate Change (MoEF&CC), a revised phased implementation plan (to be implemented before the year 2022) for installation of Flue Gas De-Sulphurization (FGD) in plants for a capacity of 1,61,402 MW (414 Units) and upgradation of Electrostatic Precipitator in plants for a capacity of 64,525 MW (222 units) has already been finalized.

22.1.1 From basic research on the internet, it is found that the capital expenditure (capex) requirement of installation of FGD equipment works out to be Rs. 50 Lakhs to Rs. 1 crore per MW of power generation. Roughly, the opportunity size of this market is Rs. 46,000 crores. Siemens, GE Power, BHEL and ABB are the major suppliers of FGD technology in India.

22.1.2 On this amount of equipment coming into the books of the power generators in the coming years, depreciation will be sought. The AO should be vigilant to ensure that the ownership of the said assets are undisputedly with the power generators (claimants of depreciation), so that there is no double claim of depreciation on the same set of assets. While doing so, the existence of asset acquisition model, such as Sale and Lease Agreements, should be seen along with the depreciation implications thereof.

22.2 When the process of liberalization of the Indian economy was set in motion, state funding of the loss-making State Electricity Boards (SEBs) was discontinued. They were required to generate funds from their own resources. Some SEBs developed the practice of 'sale and lease back of assets', which operated as under.:

22.2.1 SEBs were having old assets in their Balance Sheet, depreciation available on which was entirely used. SEBs also could not do without these assets. Hence, the SEBs revalued these assets and then sold them to entities who were looking forward to investing their funds and reduce their tax liabilities. Thus, the need of SEBs for funds was met. The purchaser was able to park its funds and claim depreciation on the same. In order to allow SEBs to use the asset, these assets were then leased back to the SEB for their use. At the end of the lease period the assets were transferred back to the SEBs or sold to some other entity.

22.2.2 There was considerable tax implication in these transactions. The SEBs being loss-making units, were not paying any taxes including Capital gains on the sale of assets, whereas, the purchasers were investing funds and getting the benefit of depreciation, and hence obtaining tax benefits.

22.2.3 In many cases of the so-called sale and lease back transactions, the transactions were found to be mere colorable devices due to the following reasons:

a. An asset which is supposed to have been sold and leased back did not cease being an asset with nominal value (not being market value as on date) merely because it's value was artificially jacked up to provide occasion for depreciation.

b. There has been multiple financing, i.e., the same asset is sold and leased back to more than one party.

c. Assets, which could not be legally sold, as they were charged to banks or others, were made the subject matter of sale and lease back transaction.

d. These were not genuine finance lease transactions because the sale price was practically returned by way of advance lease rent with the result that the entire transaction was only by way of book entries solely for purposes of tax avoidance. Where the amount was routed through a third party or a sister concern, the position was the same. In other words, there was no real finance availed by the seller-lessee, who merely made entries in the books to oblige the financier to get depreciation for such accommodation. A finance lease without an element of finance can hardly ever be recognized as bona fide.

22.2.4 Many companies which had entered into sale and lease back transactions during the mid-nineties (especially for assets which, then, were entitled to 100 per cent depreciation) were denied depreciation on the ground that the entire transaction was a sham, designed only for the avoidance of tax. Several such cases are pending at different stages before the various appellate authorities. Thus, the Assessing Officers should gather the facts of the case and apply the law including the enunciation by the judicial authorities.

22.3 Checklist for Verifying the genuineness of Sale and Lease Back Agreements:

22.3.1 An illustrative check-list for this purpose may be as under:

a. Whether Sale & Lease back transactions have taken place with proper documentation?

b. Whether the lessor provides real finance to the lessee?

c. Whether the lessor is the absolute owner with a right to lease the sale?

d. Whether the value assigned is commensurate with market value?

e. Whether the transaction is a *bona fide* finance lease, with reputed finance companies in which the assessee has no interest?

f. Whether the transactions are carried out at usual rate of lease rent. In other words, these transactions are as between principals acting at arm's length?

22.3.2 Prior to 30th September, 1996 the cost of assets in the hands of purchaser was considered to be the purchase value paid by him to the seller. Hence previously, the assets held by the seller were transferred to the other person at the price agreed between them. Subsequently, the purchaser used to give the assets to the seller on lease. Under such arrangement, the lessor was claiming depreciation on the purchase price paid by him to the seller whereas, the seller was claiming the amount of lease rentals paid by him to the lessor as revenue expenditure. In order to curb such transactions Explanation 4A was inserted in Section 43(1) with effect from October 1, 1996, to determine the written down value in a case where the assets, which have previously been used by a person (hereinafter "first person") and on which depreciation has been allowed to him, are acquired by another and the assets have been let, hired or leased to the 'first person'. In such cases, the Actual Cost of such assets shall be the written down value of the said asset at the time of its transfer (by the first person).

22.3.3 The CBDT issued guidelines for investigation into finance lease agreements (Instruction No. 1978, F.No. 225/ 190/ 98/ ITA-II dated December 31, 1999), wherein the issues to be examined while investigating the cases of such lease agreements have been delineated. The AO may examine invoking Explanation 4A to Section 43(1) in appropriate cases of sale and lease back transaction, where the depreciation is allowed to the lessor on the WDV of the asset in the hands of the lessee at the time of the transfer.

22.4 Rate of TDS

22.4.1 This issue pertains to deduction of tax at source by the owners of the power plants while making payments to the operators of the power plants. In many cases, the power plant is owned by one entity but the other entity deploys personnel and generates power. The contentious issue pertains to whether the service provided by the operator is a contractual service *u/s.* 194C or a service covered by the definition of Fee for technical and professional services *u/s.* 194J.

22.4.2 The operator, in such instances, only provides technical personnel who only come with the expertise and work on the equipment of the owner. Therefore, the deductibility of tax at source under correct Section needs to be examined. Disallowance *u/s* 40(a)(ia) may also be explored.

23. ISSUES IN RENEWABLE ENERGY SECTOR

The growth of the clean energy sector in India has been impressive. Currently, India permits FDI up to 100 per cent in the sector under the automatic route in Renewable Energy Generation and Distribution projects that are subject to the provisions of the Electricity Act of 2003. Under the Act, no prior approval of regulatory authorities is required.

23.1 Accelerated Depreciation: Under the Income-tax Act, companies involved in renewable energy such as solar and wind was provided with accelerated depreciation at 80 per cent. However, recently, by way of amendment rate has been restricted. The AO may refer to the Appendix for the purpose of applicable rates for the relevant assessment year.

23.1.1 Further, power companies have been provided with an option to claim depreciation under Straight Line Method (SLM). For this purpose rates have been prescribed separately for power generating units.

23.2 Depreciation on Wind Mills: In order to boost the use of alternate source of energy other than carbon fuels, the Government of India allowed 100% depreciation on assets used to generate power through use of Solar heat, Windmills, etc. Many Windmills were setup for generation of power in coastal areas of Gujarat, Tamil Nadu and Andhra Pradesh. The rate of depreciation allowance has undergone changes several times, the AO may refer to the Appendix for the purpose of applicable rates for the relevant assessment year.

23.2.1 However, many entities misused the scheme by making false claim of purchase and installation of the windmills. These provisions were also misused by some genuine entities that actually purchased and installed the assets, but wrongly advanced the date of installation on records to claim 100 per cent depreciation (by showing installation and use before September 30). In order to investigate such claims, following enquiries can be made:

a. Survey of the location and physical verification

b. Report from State Government about allocation of land, wind speed, etc.

c. Report from the State Electricity Development Agency about the funding of the project, installation of the asset, etc.

d. Report of the SEB about the date on which the windmill was connected to its grid and the amount of electricity generated from the same.

e. Report from the State Agency responsible for promoting use of alternate sources of energy about the units of electricity generated from the location along with date and time

23.3 Taxation of Carbon Credits or Certified Emission Reduction (CER): Taxability of receipt on transfer of Certified Emission Reduction (CER) has been subject matter of significant debate in the past. While taxpayers have claimed the same to be capital receipt not chargeable under the provisions of the Act, tax authorities have been contending the same to be business income chargeable to tax.

23.3.1 There are judicial decisions holding that receipt from transfer of CERs arises due to world concern and awareness for reduced Green House Gases (GHG) emissions and thus cannot taxed as business income. The decisions held that the amount so received has no element of profit or gain and it being capital receipts, cannot be subjected to tax in light of the provisions of sections 2(24), 28, 45 and 56 of the Act. The same has been discussed at length in the decision of Hyderabad ITAT in the case of *My Home Power Ltd*. [TS-820-ITAT-2012(HYD)] which was affirmed by the Hon'ble Andhra Pradesh High Court [46 taxmann.com 314].

23.3.2 A contrary view was taken by the Appellate Tribunals in the case of Kalpataru *Power Transmission Ltd.* [2016] 68 taxmann.com 237 (Ahmedabad Trib.) and *Apollo Tyres Ltd*. [2014] 47 taxmann.com 416 (Cochin Trib.) holding that income on transfer of CERs should be considered as benefits or perquisites under Section 28(iv) chargeable to tax as profits and gains of business or profession.

23.3.3 There is a good case for holding that the receipt on account of carbon credits is a revenue receipt on the ground that the entities would not have been entitled to CERs and would not have been remunerated for "carrying on its business in an environment friendly manner" had they not been in the business in the first place. As a corollary, the accrual of CER is from the business of the assessee and hence should be taxed as business receipts only. Since, the benefit arises from the business carried on by the enterprise, the same falls within the provisions of Section 28. This fact has been corroborated by the introduction of Section 115BBG in the Act by the Finance Act, 2017, which may be referred to.

23.3.4 It may be mentioned that the Memorandum to the Finance Bill clarifies that the said amendment is introduced with a view to encourage measures to protect the environment. Accordingly, the amendment intends to tax receipts from transfer of CERs, which are included in total income of the taxpayer, at a concessional tax rate of 10% as against corporate tax rate of 30% plus being levied by tax authorities considering the receipts as business income.

23.3.5 To summarize, the Section provides that, where total income of a taxpayer includes any income by way of transfer of carbon credits, gross receipts from transfer of carbon credits (without deduction of any expenditure or allowance) is subject to tax at the rate of 10% (plus applicable surcharge and cess).

23.3.6 Minimum Alternate Tax Applicability to CERs: As per Guidance Note on Accounting for Self-Generated Certified Emission Reductions (CERs) issued by Institute of Chartered Accountants of India to provide guidance on accounting for carbon credits, CERs should be recognized in books when those are created by UNFCCC and/ or unconditionally available to the generating entity. Accordingly, CERs generally need to be credited to profit and loss account for the purposes of book profit.

24. TRANSMISSION AND DISTRIBUTION (T&D) LOSSES

24.1 One of the issues for examination in power cases is reliability of the extent of the claim of T&D losses. The assessing officer needs to examine the quantification and genuineness of such claim. The power lost in the process of its transmission from the generating station to the end consumer is known as transmission and distribution (T&D) loss. While 'transmission loss' occurs when the power is stepped up or stepped down with the use of transformers for movement upto the point of the distribution centre, the 'distribution loss' occurs during the movement of power from the receiving station through the cables upto the consumer point.

24.2 The Transmission and Distribution system in India has been developed and linked to the generating facilities i.e. the load centre. As SEBs were the key in establishing large thermal power stations they also developed transmission network to distribute power to the consumer centre. The country had inadequate transmission, metering, communicating, and controlling facilities, which hampered the economic exchange of power between different regions.

24.3 The T&D losses can be divided into (i) technical losses caused by–inadequate and overloaded state grids, insufficient transformer capacity, and losses due to stepping up and down of the power transmission through the transformer; and (ii) normal losses in the transmission system. The T & D losses are dependent on various factors such as:

a. The distribution network system itself.

b. The existence of capacitors in the system.

c. The length and area (spread) of the distribution system.

d. The type of equipments used.

e. The voltage at which the power is transmitted-higher the voltage, the lower the loss and *vice versa*.

24.4 The type of consumers and the voltage at which the power is taken by the consumers is also a factor. For instance, if the power is sold to an industrial consumer at a high voltage of 11 KV, 33KV, 66 KV, then the T&D loss would be minimum as the entire consumption would get recorded. In the event of distribution of power to many consumers at lower voltage there would be transmission losses due to the use of step-down transformers.

24.5 Technological factors also influence the T&D losses. Earlier there was 11 KV power distribution system. Later technological improvements made it possible to transmit power at 66 KV, and then at 132 KV. Now it is possible to transmit high voltage power at 400 KV. When the power is transmitted at high voltage the transmission loss gets reduced. The transmission losses are also impacted by the medium of transmission used i.e. aluminum cables, copper cables, etc., because different metals have different inherent resistance to transmission of power. A typical city distribution system, with compact distribution areas, would have lower T&D losses as compared to a scattered state with long lines of transmission. Thus, demographic distribution of consumers and the size of power consumed by them also affects the T&D losses.

24.6 The critical question is whether the claimed T&D losses are real or there is an element of doubt on their correctness. In view of the establishment of the Tariff Regulatory Commissions at the Central and State level, the scope for overstatement of Transmission loss is open to scrutiny by the Regulator (Commission) as it is one of the factor which is seen by the Regulator while approving the electricity tariffs in respect of various categories of consumers. The utility gets negative marking for higher T&D loss than could reasonably be explained as the Regulator will not allow inefficiency by way of higher T&D loss to be passed on to the consumers. Therefore, there is little incentive for a utility to inflate the T&D losses. In case of doubt the authorities can call records of metering done at the generating point, and at the receiving point, which would yield the Transmission loss. The balance would be Distribution loss.

24.7 Wherever high T&D losses are claimed-it ought to be a gradual increase over the years because of various reasons of both-the quality of distribution system (such as quality of cables, addition of capacitors, quality of transformers etc.), or conditions peculiar to the distribution area (like consumers being spread/ scattered over large area requiring greater cable length). If the consumers use gadgets of poor quality, then also the Company would lose revenue and this would be reflected in the form of a higher T&D loss.

24.8 The greatest cause of concern in the T&D losses is the commercial loss or what is generally known as theft of power. The AO should examine any excessive claim of T&D losses. The assessing officers need to examine the T&D losses considering the facts obtaining in each case.

25. ISSUES RELATED TO APPLICABILITY OF MAT— EXCEPTIONS TO SCHEDULE VI IN THE COMPANIES ACT

Certain power generating and transmitting companies have taken the plea of non-applicability of MAT provisions in their case. The present Section 115JB was introduced from 01.04.2001. The main contention of the power generation/ transmission companies is that Section 115JB(2) requires the assessee to

prepare its profit and loss account as per part II & III of Schedule VI of the Companies Act but as per Section 211 of the Companies Act, the assessees, who are involved in the business of generating electricity are exempted from maintaining the accounts as per part II and III of Schedule VI of the Companies Act. It is contended that Section 115 JB (2) requires two conditions to be satisfied:

a. assessee should be a company
b. The provisions of Part-II & Part–III of schedule VI to Companies Act must be applicable to such company.

25.1 In the case of electricity generating/ distributing companies, it is argued by them that these conditions are not satisfied together, such companies being governed by the Electricity Act, 2003 and therefore Section 115JB will not apply. Secondly the Section 115 JB(2) requires that P&L account of such company should be prepared as per Part–II and III of schedules VI to the Companies Act. However, proviso to this Section requires that P&L account should be prepared as per accounting policies, accounting standards and methods and rates adopted for calculating depreciation in preparing accounts to be laid before the annual general meeting of the company. It is claimed that in the case of a power generation/ transmission company, it is not possible to fulfill both these conditions and for that reason the provisions of the Section 115JB shall not apply in the case of such assessee(s).

25.2 Such an interpretation of Section 115 JB(2) is **not** harmonious and not as per the intent of the legislature. **The proviso to this Section instead of being contradictory to the main provision of Section 115 JB(2) is only an *extension* of the main section.** The main Section 115JB(2) requires that the Profit & Loss Account should be prepared as per the Companies Act. However, the proviso further states that in preparing the Profit & Loss Account the accounting policies, accounting standards, the method & rates adopted for calculating the depreciation shall be the same as those which have been used in preparing the accounts to be laid before AGM of the Company. A **coherent reading of the main Section 115JB and its proviso will show that the proviso is an *enabling* provision rather than contradictory provision.** The accounts of power generating and transmitting companies, including the profit and loss account, as laid before the AGM are prepared as per the Electricity Act, 2003. Thus the profit and loss account as per the annual report of the assessee company is the one which has been prepared according to the accounting policies, accounting standards and method and rate of depreciation contained in the accounts laid before the company in its annual general meeting. Thus the annual accounts of the assessee company fulfil the requirement of Section 115 JB(2) and the first proviso under it. The book profit for the purpose of Section 115JB can be easily derived and there is no inconsistency in applying the provisions of sec 115 JB. Legislative history of the provisions of MAT makes it clear that the Electricity Companies are not excluded in Section 115JB. The proviso to Section 115 JB(2) is complimentary to the main Section 115JB and not contrary to it. Further legal arguments are elaborated in subsequent paragraphs.

25.3 Clarificatory MAT Amendment by the Finance Act, 2012: The Finance Act, 2012 has inserted an Explanation 3 under Sub-section 2 of Section 115JB. It has been clarified that for the purposes of Section 115JB, the assessee, being a company to which the proviso to sub-section (2) of Section 211 of the Companies Act, 1956 is applicable, has, for an assessment year commencing on or before the 1st day of April, 2012, an **option** to prepare its profit and loss account for the relevant previous year either in accordance with the provisions of Part II and Part III of Schedule VI to the Companies Act, 1956 or in accordance with the provisions of the Act governing such company as provided by the Income-tax Act,1961. The amendment does not

say that the provisions of Section 115JB will be applicable only from Assessment Year 2013–14 but it has only given an option to prepare its accounts as per the provisions of the Act governing the power generation/ transmission company. It shows that it has been clarified very clearly that the provisions are applicable since the inception of the Section 115JB in the Income-tax Act, 1961. The amendment is only clarificatory that the provisions of Section 115JB are applicable on the assessee.

26. INTERNATIONAL TAXATION ISSUES

26.1 Severance of Supply of Equipment and Services in EPC/ Turnkey Contracts: The taxation of Engineering, Procurement, and Construction (EPC)/ Turnkey contracts offers various challenges and opportunities. The EPC contract can be structured as a single contract or as a divisible contracts. The selection of either option can cause a significant impact on the tax costs and working capital of the project. In many cases, the power plant and the related equipment are imported from foreign entities. Such entities are also contracted for onsite installation and, thereafter, for supply of expert personnel for the operation of the equipment and also for imparting training to the domestic personnel.

26.2 Non Deduction of TDS *and* International Taxation Issues: In multiple instances, it has been found that no TDS was made on the payments being made to the foreign entities. The foreign entity claims that the supply of equipment happens outside India and, hence, is not taxable in India. Further, the services which are provided as part of installation and training do not "Make available" anything substantial to the domestic assessee. For this reason, it is contended that the same is not taxable as Fee for Technical Service (FTS). In certain cases the foreign entity asserts that the agreement is capable of being severed into a supply of equipment agreement and a supply of service agreement and reliance is placed on the decision of the Hon'ble Supreme Court in ***Ishikawajima-Harima Heavy Industries Limited vs. DCIT*** ("Ishikawajima") [2007] ***288 ITR 408*** (S.C.) to claim that the receipts are not taxable in India.

26.2.1 In all such cases, the contract agreement should be called for by the AO and should be examined meticulously. In many instances, it would emerge that the agreement cannot be severed into supply of equipment and services, but in fact, is a Composite agreement for the installation of power plant with clear "cross breach fall Clauses" wherein the failure/ dissatisfaction in one part of the agreement would make the entire agreement as null and void. The facts of the case can then be distinguished from that of *Ishikawajima-Harima Heavy Industries Limited* (supra). Consequently, it can be established that the payments made for the import of equipment and services needs to be brought to tax in India (to the extent attributable in India). As a result, TDS needs to be made on the same. In default, disallowance under **Section 40(a)(ia)** needs to be considered.

27. TRANSFER PRICING ISSUES

27.1 Shifting of Profits in Inter-unit Transfer between Eligible and Non-Eligible Units: The power sector has entered the domain of transfer pricing verification since the introduction of the provision relating to specified domestic transactions (SDT). As per these provisions, the transactions between tax exempt and tax paying entities are subjected to scrutiny to identify whether the same had been undertaken under arm's length price conditions or uncontrolled/ third party conditions. Since, the entities generating power are eligible for deduction *u/s* 80IA of the Act, there is a possibility that the profits of these entities are inflated by charging higher prices or booking lower cost allocations to these entities/ units. The investigations which have been carried out in the recent TP Audit cycles for which SDT transactions have been examined, significant tax

evasion by booking higher than the ALP prices for the sale of power have been detected by the transfer pricing officers.

27.2 The major issue which has emerged is that the power generating units sell power to other sister entities which are engaged in manufacturing activities, e.g., a cement plant has a captive unit generating power and catering primarily to the requirements of the cement plant. Only in case of surplus the power is sold to third parties or electricity exchanges and in certain cases, some power is mandatorily sold and fed to the government power distribution grid. Many a time, however, the manufacturing units need to buy power from external sources which are mainly the state electricity distribution entities. It has been more or less a uniform practice that the price at which power is purchased from the distribution entities is used as the price for the computation of revenue for claiming the deduction of eligible power unit. In the terminology of transfer pricing, the assessee has used a comparable uncontrolled price (CUP) which is the price at which the manufacturing or non eligible entity or unit buys power from the distributor entity or the market. The comparison that has been done by the assesses while taking such a stand is that the transfer price rate is the alternative source rate and had the captive unit not been available, the rate at which power would have to be purchased by it from the available alternate source is a valid CUP. In other words, the assessee is comparing the rate at which a power purchase transaction has been made with a sister entity with the rate at which power has been purchased from an independent or third party.

27.3 This argument of the assessee has not been found to be valid one when the underlying principles of transfer pricing are applied. In transfer pricing, the crucial elements are FAR which is the acronym for Function Asset and Risk. If the FAR of the transaction is same or similar, then only the prices under CUP method are comparable. In the particular instance, the third party from whom power has been purchased is a distributor of electricity and is not a generator of electricity. The assets which are owned by the distributor include transmission and distribution lines, load dispatch Centres as well as supporting manpower and technical equipment to help the function. This is not a requirement of a captive power producer which operates on equipments like boilers and turbines, etc. Functionally, the power generator is a manufacturer of power, whereas, a distribution entity is a distributor or trader. The inputs for the power generator would include raw materials *viz.*, fuel, steam, water etc. On the other hand, the input for the distributor is a finally produced power itself and it does not do any processing to convert power into some other product. Considered thus, the two entities are not functionally comparable. As regards the risks, the major loss of the distribution entities is the transmission and distribution loss which is completely inapplicable for a power producer. Therefore, considering the FAR analysis, the prices that a power producer charges cannot be compared with the prices that a power distributor charges. Resultantly, adjustments have to be made to the rate for the functions that the power producer does not do in order to arrive at the appropriate CUP for the transaction. A convenient and valid way to do so is to find the rate at which power has been purchased by the distributor to which it has added value and sold to the power consuming entities. Therefore, the rate at which the power is purchased by the distributor from whom the assessee has purchased power is a valid CUP and not the rate at which the distributor has sold power. It is pertinent to mention that this valid adjusted CUP rate also takes care of the profit margin that would have been charged by the power producer while selling power to the distributor. This is an adjustment which is to be looked at by the TPO on a reference made by the AO.

27.4 Another way of arriving at the appropriate pricing could be the determination of the cost of supply of power for similarly placed power

producers and allowing them a return on capital, which is the criterion for profitability of the thermal power units as per Central Electricity Regulatory Commission (CERC) guidelines.

28. Case Study: In one case, the assessee had procured 255 million units (MU) of power from its AE which was an 80IA eligible unit. Towards this, the assessee paid a fixed charge of Rs. 1.75/ Unit to its AE. From the perusal of the power purchase agreement, it was learnt that the assessee would supply fuel, raw water, service water/ potable water and provide other utilities like switchyard required for generating the contracted portion of power FREE OF COST to its AE. The assessee was asked to submit a comprehensive cost sheet incorporating the costs of all the above items. The assessee then arrived at a cost price of Rs. 4.27/ unit. Thereafter, the price at which the power producers were selling power in the vicinity was examined. An independent search was carried out on the website of IEX (Indian Energy Exchange), where the average cost of power sold by all the power generators in a particular region is available. The Arm's Length Price (ALP) of power purchase was arrived at Rs. 2.51/ unit as against Rs. 4.27/ unit claimed by the assessee. Consequently, an adjustment was made to its income.

29. In many cases of captive power plants, SDT transactions were scrutinized for determination of ALP of power sold by eligible unit to non-eligible unit. Enquiries were conducted *u/s.* 133(6) and rate of power purchased by SEBs and other entities functioning in the same region were collected and used as external CUP for the purposes of determination of ALP. This resulted in downward adjustment of ALP and consequential reduction in allowable deduction *u/s.* 80IA.

30. Purchase of Coal from AEs: In certain cases, power producing units may have entered into international transactions (or SDT) with Associate Enterprises (AEs) for purchase of coal. The TPO should explore the possibilities of using CUP method. In this regard, he may examine similar transactions undertaken by purchasing and selling parties with independent entities. Further, data available in the public domain, like TIPS database, Bloomberg Database and other Indices in vogue in various countries capturing information of exports and imports, may also be explored for application of external CUP.

31. Financial Transactions (Loans and Guarantee): Since power plants involve huge outlay of funds and are generally leveraged, there are financial transactions of loans and guarantees between the Associated Enterprises. The TPO is required to examine these transactions for bench marking purposes. He should conduct FAR analysis and proceed to determine ALP. One of the important aspects in benchmarking of loan transactions is the currency in which the loan is to be repaid. This is because the foreign currency fluctuation risk is associated with the currency in which loan is to be repaid. It has been so held by the Tribunals/ Courts (refer to the decision in the case of Cotton Naturals–Delhi High Court). The TPOs, of late, have started using Bloomberg Database for benchmarking of loans by conducting search into loan transactions using various filters. In addition to the transactions of loans between the AEs, the TPOs also come across the issue of benchmarking of guarantees (corporate guarantees, performance guarantees, letter of comforts). These transactions, after due examination of FAR, may be benchmarked using CUP data or by way of interest saving approach.

CHAPTER

12

Ship Breaking Industry

1. INTRODUCTION

1.1 Ship breaking is the name given to the industry in which old and discarded marine vessels are acquired, and completely dismantled. Alang & Sosiya is the hub of ship breaking activity in Gujarat. Alang, is a small town situated in Bhavnagar district of Gujarat state. In the past 3 decades its beaches have become a major worldwide Centre for Ship Breaking. The longest ship ever built "Sea wise Giant" was beached and demolished in Dec 2009. There are 183 ship-breaking plots in Alang and Sosiya villages. Together, they account for breakage of over 350 vessels per year, with aggregate weight of over 26 Lakh tons. Large super tankers, car ferries, container ships and occasional ocean-liners are beached during high tide and during low tide hundreds of manual laborers dismantle the ship salvaging anything that is reusable and reducing the rest to scrap, for usage in ancillary business such as Re-rolling Mills, Ingots mfg. etc. During the year 2012–13 total 394 vessels were demolished at the Alang and Sosiya Ship breaking yards near Bhavnagar. One has to find out a geographically suitable beach for such activities.

1.2 Ship breaking requires a particular gradient of slope of the sea. The gradient should be very steep at the beach, and thereafter, for some distance, it should be shallow so that during high tide, the ship can reach up to the shore, and can be berthed right on the shore. Thereafter the ship is dismantled beginning at the front and is pulled towards the beach as it is dismantled. The Alang and Sosiya Ship breaking yards near Bhavnagar in Gujarat, situated on the Gulf of Cambay on the west coast of India, is considered one of the most suitable locations for ship breaking.

2. GENERAL INFORMATION

2.1 The availability of ships for dismantling depends on the international cargo freight market. When the cargo traffic and international freight rates are high, availability of ships for dismantling becomes low and prices of ships go up. Similarly, when international freight rates and cargo traffic is low, more ships become available for dismantling at lower prices.

2.2 When the owner of a ship feels that a particular ship is to be disposed off either because it is no longer economical to run it, or because the ship has met with an accident, he contacts one of the several Agents who mediate in selling of ships, stationed at London, Dubai, Hong Kong or Singapore. These agents contact their subagents stationed in India, most of them located at Bhavnagar. The subagents keep in touch with the local ship breakers, who may be on a lookout for ships, mostly because they would already have dismantled the last ship purchased or would be shortly completing the process. The information about availability of ships, the description of the ships, including its name, height, width, name of the yard where it was built, make and capacity of various generators, engines, motors and other similar details are sent to the prospective buyers. On receipt of this information, negotiations between the subagents and the ship breaker commence, and the price is settled. The prices are in terms of US Dollars per ton. Once prices are settled, a Memorandum of Agreement (MOA) is signed between the seller and the buyer, in which details of the ship are mentioned along with the rate at which it is to be sold, the number of propellers and extra propellers, metal of which the propellers are made, time-period during which the ship is to be delivered etc. Once this agreement is entered, the seller brings the ship to the safe anchorage in India. There the ship is inspected by the prospective buyer to verify whether it is as per the MOA executed by him. If the ship is as per MOA, it is agreed to be purchased and the ship breaker opens a Letter of Credit with the bank and releases the same to the seller. If the ship is not as per the MOA, the prospective buyer either rejects the deal, or bargains with the seller for a lower rate.

2.3 Thereafter, the officials of Customs department rummage the ship, to check whether the ship contains any cargo, as ships with cargo are not permitted in the ship-breaking yard. In case, the ship has some cargo, it is liable to be confiscated. The Customs also prepare an inventory of oil and lubricants contained in the ship, and of electronic goods and goods of consumption. Any sophisticated communication equipment on the ship is to be completely destroyed by the Customs authorities so as to prevent the same from falling into wrong hands. "Sounding" of quantity of oil is taken by the Customs authorities, and also by an independent Surveyor of ships. Once these formalities are completed, the ship is "beached" in the "plot" of the ship breaker. These "plots" are of various sizes varying from 30x 90 meters to 120 x 90 meters. The "beaching" of the ship can take place only during high tide. As discussed earlier, the gradient of slope is very high at the beach, and thereafter the sea is shallow. Thus, during high tide, the ship can travel right up to the beach. Once the ship is berthed, it is tied up with heavy metal chains attached to 2 to 4 Winches. Thereafter, advance payment of customs and central excise duty is made, and oil and lubricants are unloaded. Only after unloading oil and lubricants, permission to cut the ship is obtained in writing from the Maritime Board and Customs, and thereafter, cutting of the ship is commenced. First of all, the cabin along with furniture, fixtures, furnishings, electrical and electronic items, is disposed off. Thereafter, dismantling of other parts of the ship commences. The ship is dismantled from front and, simultaneously with dismantling, is pulled towards the beach.

3. DETAILS OF DOCUMENTS EXECUTED

3.1 The following documents are executed before dismantling of ship commences:

a. Memorandum of Agreement (MOA)

b. Letter of Credit (L/C). Proforma of a typical L/ C is given in Annexure-7.

c. Permission of boarding from Customs authorities.

d. Permission of beaching from Customs authorities.

e. Bill of Entry, and the inventory of bunkers, foodstuffs, drinks etc.., prepared by the Customs authorities.

f. Survey report, generally by an independent Surveyor of ships.

g. Notice of readiness for delivery, physical delivery certificate, (Proforma in Annaxure-9), deletion certificate, non-encumbrance certificate, trim & stability booklet containing a blue print of the ship.

h. Bill of sale or commercial invoice.

i. LDT certificate from the shipping yard.

j. Challans for payments of Customs duty, and various charges to Maritime Board.

k. Permission for breaking the ship obtained from Customs, and Maritime Board.

l. Safety permit and Naked light certificate, under the Factories Act.

3.2 MOA is executed between the seller of the ship and the ship breaker on settlement of price and other terms of sale. It contains following details:

a. Rate in US Dollars per Light displacement ton (LDT), and total price of the vessel.

b. Name of the vessel, its old names, place of registration, name of the yard where it was built, length, breadth and the weight of the ship; type of engine, generator, propeller, spare propeller, if any, spare tail shaft, if any, permanent ballast, the type of construction of ship etc..

c. Mode of payment, mostly by irrevocable letter of credit, opened with the bank of the ship breaker and negotiable at the counters of the sellers' bank, payable to the seller. Time of tendering "Notice of readiness".

d. Documents agreed to be provided by the seller to the ship breaker, e.g.:

e. Signed Commercial Invoice and Bill of Sale with description of the vessel

f. Certificate that the vessel is free from encumbrances/ debts/ mortgage/ lien etc.

g. Undertaking from seller that immediately on receipt of full purchase price, the vessel will be physically delivered.

h. Certificate of deletion from registering authorities where the vessels is registered, to be provided within two months.

i. Whether vessel is "laid-up" or is to be delivered on the strength of its own power (laid-up vessels are cheaper).

j. Certificate of a reputed licensed Surveyor certifying the metal of which the propeller is made, (non-ferrous propellers are valued at 6 to 10 times the value of ferrous propellers) and also whether the weight of the vessel is as per the "trim and stability booklet".

k. The buyer also undertakes not to resell the vessel under any circumstances.

3.3 Letter of Credit is released by bank of the ship breaker to the bank of the seller, as agreed in the MOA, upon receipt of Notice of readiness from the seller. The L/C is irrevocable.

3.4 Permission is obtained from the Customs for boarding of vessel for physical inspection, to verify whether the ship is as per terms agreed in the MOA. If the ship is as per MOA, the ship breaker agrees to purchase the ship, and approaches the Customs to permit beaching of the vessel at its plot.

3.5 A Bill of Entry is prepared by the ship breaker. It contains description of the type of oil, stores, supplies, consumable goods, electrical and electronic goods found in the ship. On the basis of this declaration, customs duty is paid on the said goods. This is an important document. The quantity of furnace oil, light diesel oil, lubricating and cylinder oil, and various other oils is mentioned in the Bill of Entry. In the assessment proceedings, the AO may verify whether these oils, stores and other supplies, have been disclosed either as Sales or as closing Stock. It is normally claimed that part of the oil was irrecoverable while some part was consumed by the ship between the time of its inspection and it's beaching. However, as discussed later in this Chapter, this argument can be misleading. It is at times claimed that water was found mixed with the oil. It may be noted that usually a certificate is given by the Master of the ship, Chief Engineer and the Superintendent Customs that no water is found in the oil tanks. Another document called "Inventory of bunkers, food stuffs, cold drinks and other ship stores" is also prepared. This is a declaration of the Master of the ship, duly verified by the Customs.

3.6 Surveyor's Report: Survey of the ship is conducted by Licensed Surveyors, most famous of them being M/s Ericson and Richards. The Survey report contains verification of the metal of which the propellers are made up. The Surveyor also takes "sounding" of oil and certifies the quantity of oil. They also certify whether the "trim and stability booklet" is found on the ship, and whether the ship has any leakage, ingress etc.

3.7 After the ship has arrived at the anchorage, and is ready for delivery, the Master of the ship informs the Indian agent of the ship owner, that the ship is ready for delivery. This, in turn, is communicated to the purchaser, and the L/C is released by the ship breaker's bank to the seller's bank. At the time of handing over of the ship by the Master of the vessel to the agent of the ship breaker, the Master also hands over a physical delivery certificate stating therein, that the ship is being handed over to the said person in good floating condition. Within two months of sale of the ship, the seller provides a deletion certificate from the registering authorities that had registered the vessel, stating that the name of this vessel has been deleted from their register. Light displacement tonnage (LDT) certificate is obtained from the ship-breaking yard where the ship was constructed. There is a register called Lloyds' Register of Shipping, which is customarily accepted in International Shipping trade, as authoritative record of ships operating in international waters. It contains details of all old names of the ship(s), the shipyard where it has been constructed, and the bio-data of the ship. Further, to verify the details of the ship, the ship breaker calls for LDT certificate from the yard in which it has been constructed.

3.8 Bill of sale and commercial invoice mainly state the details of the ship along with the fact that the ship has been sold to the ship breaker.

3.9 Once the custom duty is paid, and the oil & lubricants have been removed from the ship, Customs and the Maritime Board permit the ship breaker to start breaking of the ship. This permission is conditional upon the ship breaker certifying that all oil has been removed. Thereafter, the Safety work permit and the Naked Light Certificate are obtained from authorities under Factories Act, and the dismantling of the ship commences.

4. TYPES OF YIELDS

The dismantling of ships yields Industrial machinery (lathes, boilers etc.) Electrical machinery (Generators), Petroleum products (Fuel Oil, Lubricants), Industrial materials, metal (Ferrous and Non-ferrous sheets), Electrical, electromechanical & electronic appliances, (Generators, Domestic wares (Cutlery, Crockery, linen), Communication equipment, Navigation equipment & accessories, Tools and tackle, foods and beverage, furniture and fixtures,

sanitary items and Safety devices etc. Further, the recovery of ferrous and non-ferrous metals is approximately as per Annexure-1. Most of the material recovered, comprises ferrous metals. However, the most valuable items in the ship are non-ferrous metals, which sell at up to 10–15 times the rate of ferrous materials. Large tax evasion is possible by understating the yield of non-ferrous materials, and instead, disclosing a higher yield of ferrous materials. The yield of the non-ferrous material depends upon the type of the ship.

5. METHODS OF SHIP BREAKING

5.1 The main methods of breaking the vessels into big blocks of iron plates are:

a. Dry dock method

b. Vessel moored at quay

c. Stern of the vessel moored towards the quay

d. Side of the vessel moored along the quay

e. Vessel grounded in the shallow that is beaching method

f. Special methods e.g.-Berthing on finger jetty; Fixed platform; Shiplift; Floating jetty

5.2 Different ship breaking yards specialize in different methods of ship breaking & the same is being tabulated in Annexure-2**.** Similarly the main equipments used in the ship breaking are tabulated in Annexure-3**.**

6. METHODS OF TAX EVASION

6.1 Understatement of Production/ Yield/ Sales: Since the dismantling of a ship results in recovery of numerous types of material, most of which are measured in different units, it is not really possible to keep a complete day to day quantity record of the recoveries of each of these products. Besides, there are various losses in the process of ship breaking, e.g., cutting loss arising on gas cutting of metal plates. In addition, since the LDT of a ship represents its weight at the time of its construction, it is possible to argue that the weight of the ship when it was delivered to the ship breaker, was much less than its LDT due to corrosion etc., suffered by the ship in its operational life. Thus, quantity-wise tally of the ship cut, and the material recovered is an extremely difficult, if not impossible, proposition. This provides considerable scope for unscrupulous ship breakers to manipulate production records/ data, and the valuation of closing Stock to suit their convenience. Further, since non-ferrous metals recovered are far more valuable than ferrous material, showing higher recovery of ferrous material and lower recovery of non-ferrous metals, has the advantage of showing good recovery in weight, but a lower figure in terms of value/ price. This unstated/ understated production of various materials is then disposed of outside books. In this connection reference can be taken from the fortnightly statements of Stock submitted to the banks (see Annaxure-8). The same can be useful for verifying this issue. Further, co-relation can also be made with GST authorities to whom monthly returns in the form of GSTR-1 are required to be submitted as per the prescribed Proforma. GSTR-1 is a monthly return of outward supplies. Essentially, it is a return showing all the sales transactions of a business. If a person has entered into a transaction of supply of goods, then there must be someone who would be the recipient of the supply of goods. Supplier of the goods would be originating point of the transaction and he would specify, in his return, details of the supply along with the recipient to whom supply has been effected. Thus, GSTR-1 is the base document which can be useful for us to cross-verify the claim of the sales. GSTR-1 can be compared with the sales book/ Monthly Stock statement submitted to the bank.

6.1.1 Sale Invoices are prepared at figures lower than the actual rate at which the goods have been sold. The bill amount is taken by

Cheque/ Demand Draft and the balance is taken by cash. This activity is carried out not only in respect of local Sales but also outstation Sales. For example, in the course of a search, it was found that bills were issued at 70 to 80% of the prevailing market rate for the class of commodity. This amount was received by Demand Draft, while the balance was received in cash through the brokers. The purchaser was sending cash through angadia (courier), who would pay the cash amount to the broker, and the broker would make payment to the ship breaker.

6.1.2 Another method is to make cash sales at market rate, without issue of bill and without recording in books. Later, when cash is needed in cashbook, this cash is introduced in the guise of Sales, albeit at a lower rate. The ship breakers have to keep account of the weight of the goods sold by them. There is little scope for manipulation of weight, although this is also being indulged in. However, most of the manipulation is being done in the rate of sale. For example, if market rate for certain category of steel plates were Rs. 32,000/- per ton, the Sales would be shown at Rs. 30,000/- per ton in the books. The balance Rs. 2,000/- will be siphoned away by the ship breaker. What makes things easy for the ship breaker and difficult for the department is that different grades of steel are obtained from dismantling of ship, while same type of bill may be issued for the entire disclosed ferrous production, i.e. for mild steel. The bills may not mention the grade of steel, which has been sold. For example, steel of various thickness like 1", 0.5", 0.75" are sold, but the bills may only show 'mild steel plate', without any description about the quality or type or grade, or thickness of steel. This problem is further compounded because the price of steel changes almost every day. Although the daily change is not very large (plus or minus 1% to 2%), but since the rate is not uniform, and there is no agency to keep watch on and/ or publish these rates. Again, the nature of the sales is scrap sales. Therefore, it becomes very difficult for the department to establish the market rate on a given day. Thus, large cash Sales are affected without issuing bills. When large amount of cash gets accumulated, the requisite amount is introduced in the books as sale proceeds of Sales made to certain local traders, who may be genuine parties, but to whom no Sales would have been made.

6.1.3 Information found during searches against many ship breakers, has brought out that the ship breaker first deposits his unaccounted cash in the bank accounts of such parties, and then sale bills are issued in the names of these parties, and the amount is shown as receipt of sale proceeds from these parties through cheques/ DDs. These parties are paid small commission in cash, for their services. These parties are generally active for certain period only. Thereafter they would shutdown their business and start afresh with new name. They have complied with all agencies i.e they have filed their return but shown meager income or in case of indirect taxes they have shown their transactions at break-even margin. So, it is difficult to establish their bogus nature through assessment and shallow office enquiries. Thus, the cash collected by the ship breaker from unaccounted/ unrecorded sales is pumped back into business. The main benefit, which accrues to the ship breaker by such transactions, is that, Sales are disclosed not at the going market rate, but at a much lower rate. Further, since the market rates are not easily ascertainable, and the quality of steel sold is not mentioned in the bills, it is not possible for the AO to find out the understatement of Sales. It is advisable to make random checks of sale rates, with those shown by other ship breakers on the same day, it may help.

6.1.4 During various actions it is also found that it is a compulsion for a ship breaker to sell their stock as early as possible by whatever means i.e cash/ cheques. In the ship Breaking Industry it is a general practice that all ship breakers buy their ships through bank loans (CC/ LOU). For this bank loan they have to pay a good amount

as interest. So in order to save this interest their primary focus is to finish the existing stock early, as possible, by way of cash/ cheques sales. For example-a ship breaker avails a bank loan of Rs. 40 crore. Now, if we calculate the interest @12%/ annually then that ship breaker needs to pay around Rs. 40 Lacs/ Month as an interest. Thus if a ship breaker sold their stock a month early then it will directly increase his profitability. Therefore they always try to sell their stock by whatever means as early as possible. By making the cash sales they generate huge cash. Thereafter, in order to adjust the cash received from the cash sales they have shown their sales to various furnace plants/ rolling mills who in turn purchases their stock from various scrap vendors/ cash sellers in cash only because they also want to regularize their books. This way they would take the bill entries of purchases from the ship breakers and purchase the stock from various scrap vendors/ cash sellers. This way both can successfully regularize their books at agreed price and suppress the profit. In this scenario, the AO can take the reference from the GSTR-1 and can conduct random checks with the sale rates shown by other ship breakers on the same day.

6.2 Sale of Oil and Lubricants: While the ship is in safe anchorage in sea, it is inspected by Customs along with Surveyor of ship. They take "sounding" of oil, as also the meter reading of the oil tank. On this basis, they determine the quantity of various categories of oil and lubricants like diesel oil, furnace oil, grease etc. in the ship. They certify this for levy of customs duty. These details are available with the Customs in the "Bill of Entry". This document is an excellent basis to judge whether the sale of the full quantity of oil and lubricant present in the ship has been disclosed by the ship breaker subject to consumption of oil during the period of stay at the Anchorage. More often than not, it has been found that sale of only 50% to 75%, of the quantity as disclosed in 'Bill of Entry', is disclosed in the books of accounts. It is explained that while sounding and reading of oil is taken in high sea when the ship is berthed at a distance of 20 to 25 kms from the ship-breaking yard, the ship is beached upto 15 days after taking this reading. It is claimed that during the intervening period and distance, oil and lubricant is used up. However, this argument is, to a large extent fallacious. Actually shortage in the oil depends upon the various factors which includes the situation of the tank, tank calibration, the temperature of tank, balance of the tank, type of vessels, last voyage of the ship, the density of oil, the working life of the ship, the period after working lie to anchoring point, the stitch of oil with tank etc. It may be noted here that the engine of the ship uses furnace oil for running the ship and the generator uses diesel oil which supplies electricity to the rooms, kitchen etc. When the ship is anchored at high sea, only one or two generators of the ship remain working, and the engine of the ship is shut down. There is, thus, no question of using up any furnace oil since the engine is shut down. The generators can also not use more than, say, one Metric Ton a day. Thus, only some margin can be given for the consumption of oil by generators and for travelling from anchorage to berthing. The balance quantity should be disclosed by way of Sales. Very often, the ship is brought from anchorage to ship breaking plot by tugs, i.e. it does not travel on its own power, and is pulled by another vessel. In such cases, there is no question of consumption of fuel oil after the reading by Customs. If such disclosure is not made, the AO may take suitable measures.

6.3 Sale of Cabin Items: Each ship requires several crew members to run it. Bigger the ship, more the crew members. All these crew members have to be properly housed and fed. Besides, they all have their working place on the ship. Thus, ample space is provided for kitchen, bedrooms, working place, sophisticated equipment, common room, bar room, emergency medical room, stores etc. These cabins contain furniture,

electric, electronic items like fridge, TV, VCR, CD players etc., depending on the type of the ship, the country to which it belongs and date, when it is refurnished etc. Further, the cabin is made of such items as plywood, fiber, fire wood, teak wood etc. It also contains glassware, crockery, cutlery, and sanitary equipment. When the ship is beached, various parties contact the ship breaker with offers to purchase all the above-mentioned items. The ship breaker accepts the best offer and all the above items are usually sold in a lot. While dismantling and handing over these items, they are weighed and note of these Sales is kept. Later in the books of accounts, the assessee does not disclose these Sales to have been made as a lot to one party. Instead, he discloses some Sales of plywood, firewood, teak wood, sofa, chairs etc. and such other items separately to separate parties. Thus, often while the cabin items are sold to one single party as a lot, in the books of accounts, the ship breaker discloses sales to number of parties, and of number of items, all by weight. Here the AOs need to take care that the rates of GST is different for different items and detailed analysis could result the suppression of some precious electronic and fixture items sale.

6.4 Sale of Machinery Items: Items like machinery recovered from the ship cannot be properly valued. The AO need to properly scrutinize the sales of the items like Motors, Generators, Cranes, Cylinders etc. There are plenty of buyers available in the market who can buy these items at any point of time. These are heavy demand items and normally ship-breakers try to show the sales of these items either on the lump-sum basis or according to their weight (as scrap sale). In fact a ship breaker himself does not know how much, for example, a lathe machine would fetch him. Depending on the customer, market situation, urgency of need the price of an item may vary 2 to 3 times. Further, there are no norms on which to value such Stock i.e. at going market price, cost or market price whichever is lower, or cost method etc. Thus, there is always ample scope to under-value the closing stock. Therefore, the AO needs to verify the sales of these items on the basis of the size, utility, demand and sale recorded by the assessee in the books. Usually these machinery items are sold to willing purchaser but the ship breaker discloses sales all by weight. Thus, they suppress the actual amount of sales. Here the AOs need to take care that the rates in GST is different for different items and detailed analysis could result the suppression of some precious machinery items sale.

6.5 Valuation of Closing Stock: The closing stock of the ship breakers comprises of part-cut ship, unsold machineries recovered from the ships in working condition, ferrous scrap, non-ferrous scrap, ropes, wires, tools, implements etc. At least, one of these items *viz.* part-cut or uncut ships cannot be weighed. Thus, one cannot say with certainty whether 40% or 30% or 20% of the ship being cut, has been cut. There would always be a margin of error in the estimation of the uncut ship. This seemingly small margin of error of, say 10 to 20%, can mean a variation of 500 to 1000 tons that is Rs. 50,00,000/- to Rs. 1,00,00,000/-. Usually ship breakers furnish fortnightly stock statements to banks. A typical proforma of such statement is given in Annexure-8. This may be useful for verifying the correctness of the closing stock disclosed to the department and of course reference can be taken from the GSTR-1, which contains monthly details of outward stock.

6.6 Payment of Black Money for Purchase of Ship Breaking Plots: All Ship breaking plots in the state of Gujarat belong to Gujarat Maritime Board, which assigns permission to utilize these plots on payment of certain charges. This permission to utilize ship-breaking plots is transferable. Thus, on paper, one ship breaker may transfer the permission of Gujarat Maritime Board to utilize the ship-breaking plot, to another ship breaker. Although, in practice, the plot is transferred along with building, machinery etc., in the books, often the ship breakers disclose

such Sales at a nominal rate, on the ground that the plot belongs to the Maritime Board. In one case, where a ship-breaking plot had changed hands, on enquiry, it was found that the plot was actually sold for handsome amounts. However, when the matter was further examined, it turned out that most of the amount was paid for transfer of machinery (crane, winch etc.), building and some land near the ship-breaking plot. However, no money had been shown for transfer of the permission of the Maritime Board to utilize the ship-breaking plot. This effectively meant that the plot had been transferred without any consideration. In another case, it was seen that a very small amount had been paid against the permission to utilize the ship-breaking plot. The explanation was that these plots were reserved for scheduled castes and scheduled tribes, and there were no takers for the same. In another case, the explanation offered was that the beach appurtenant to the said plot was rocky and therefore the plot commanded lower price. Someone else in this situation claimed that the beach appurtenant to the plot was muddy and therefore the plot fetched a lower price. Thus, there are reasons galore, which are cited above just as an indication of the nature of manipulation possible. The AO can call for details of transfer of plots from the Maritime Board. Evidence found during searches revealed that actually the ship breaking plots, being few in number, command a very high premium in black market, and usually their transfer involved exchange of large amount of black money. Therefore, it is necessary to obtain full details from the assessee and the Maritime Board, and compare these with the rates at which others have sold their plot at the same time.

6.7 Usance Interest: Before purchase of a ship, the ship breaker signs the MOA with the seller of the ship, containing full particulars of the ship. One of the conditions normally (if the ship is purchased by bank finance), is that an irrevocable L/C has to be opened by the ship breaker for a period of 6 months from the date of delivery of the ship. The payment for the ship is made on the expiry of 6 months from the date of delivery at the ship-breaking yard. For these 180 days, the ship breaker has to pay interest on the credit extended. This interest is generally paid to a non-resident against the credit facility availed for purchase of ship. Section 9 (I) (v) provides that if interest is being paid to a non-resident, then the interest payment is deemed to accrue or arise in India. Therefore, tax is required to be deducted u/s 195, from the interest paid/ payable to the nonresident. If such tax deduction is not made, Section 40(a)(i) stipulates that the interest paid to the non-resident, cannot be allowed as a deductible expenditure.

6.7.1 However, in this connection, the change in Section 10(15) vide Taxation laws (Amendment) Ordinance 2003 also merits attention. The amendment states that:

"Clause (15) of Section 10 is a long provision dealing with exemptions in regard to various categories of interest incomes. One more category of such exempt income has been included in this sub-section by adding a new sub-clause (iiib) with effect from April 1, 2001 which reads thus:

"(iiib) interest payable to the Nordic Investment Bank, being a multilateral financial institution constituted by the Governments of Denmark, Finland, Iceland, Norway and Sweden, on a loan advanced by it to a project approved by the Central Government in terms of the Memorandum of Understanding entered into by the Central Government with that Bank on the 25th day of November, 1986."

6.7.2 A new Explanation (numbered Explanation 2) has been added to sub-clause (iv)(c) of clause (15) to clarify that 'usance interest payable outside India by an undertaking engaged in the business of ship breaking in respect of purchase of a ship from outside India shall be deemed to be the interest payable on a debt incurred in a foreign country in respect of the purchase outside India. Further, in the Explanation 1 occurring below item (i), after

Clause (d), the following Clause shall be inserted and shall be deemed to have been inserted with effect from the April, 1, 1991, namely:

"(da) the business of ship breaking; or".

6.7.3 In a decision in respect of this Section rendered in the case of *Vijay Ship Breaking Corporation vs. CIT [2008] 175 Taxmann 177,* the Supreme Court held that TDS obligation arises only if the tax is assessable in India. Since in this case usance interest was read as exempt under the Act, the Apex Court held that there was no question of TDS being deducted by the assessee.

6.8 TDS on Transportation Charges: One ossf the important inputs for cutting of ships is oxygen gas. LPG is burnt with oxygen to produce a flame, which cuts ships. Oxygen is provided by the oxygen manufacturewrs, some of whom are sister concerns of the ship breakers. The oxygen is supplied in cylinders, and as per normal business practice, a comprehensive payment for oxygen manufacturing charges, cylinder hire rent, and cylinder transportation, is made. Thus, this transaction is in the nature of a work contract. Therefore the person responsible for paying any sum to the contractor for carrying out this work, is required to deduct tax @ 2% of such sum. However, more often than not the provisions of Section 194C are not complied with. After implementation of GST, the AO can check the purchase bill, where nature of the sale/ services is specified and GST applied accordingly and take the action accordingly.

6.8.1 In fact after rolling out the **E-way bill mechanism**, things would be much easier than ever. E-way bill is an electronic documentation meant for tracking all the inter-state movement of goods. This bill can be generated on the E-way bill portal. Post registration, for a specific delivery a unique E-way bill number (EBN) is allocated to the supplier, recipient, and the transporter. This e-receipt captures all the details of the goods being transported right from point of origin of the consignment, its destination and route, to the name of the consignor as well as the consignee. Thus an E-way bill has to be generated for all movement of goods—within or outside a state—valued at more than Rs 50,000 by prior online registration of the consignment. The supplier and the transporter can upload the details about the shipment. An e-way bill will be valid for a day for a distance less than 100 km. For every 100 km thereafter, the validity will be an additional day from the relevant date. As per the Rule 138 of the CGST Rules, 2017 with reference to E-way bill mechanism states that 'information is to be furnished prior to the commencement of movement of goods' and 'is to be issued whether the movement is in relation to a supply or for reasons other than supply'. Till 31st May 2018, E-way bill generation for intra-state transaction was optional. However, from 1st June 2018 onwards, generation of E-way bill needs to be done for all types of transactions where the distance is more than 10 km. Thus from the E-way bill The AO can cross-verify the claims of the transporters/ suppliers. With the help of the E-way bill the AO can also cross verify the details of the actual seller/ purchase/ value of the goods etc.

6.9 Compliance with the Provisions of Section 145A of the Act: In view of the provisions of Section 145A of the Act, the assessee is required to determine its total income by adjusting the purchase, sales and inventory by the value of tax, cess, duties, fees, etc. actually paid or incurred. Accordingly, when the assessee specifically companies follows exclusive method of accounting for purchases, sales, the assessing officer is required to check and examined the effect of adjustment of duties, taxes, cess, levies, fees, etc. to the purchases, sales and inventories. Currently, indirect taxes are covered under CGST Act and IGST Act. Accordingly, the assessee is required to pay Custom Duty and IGST (i.e. Integrated Goods and Services Tax) on the assessable value of the ship determined as per Bill of Entry e-filed by the assessee. The AO is required to examine

the Bill of Entry and Challans of Custom Duty and IGST paid on the import purchase of ships for demolition. In case of the assessee following exclusive method of accounting in violation of the provisions of Section 145A of the Income-tax Act but in accordance with the Accounting Standards issued by the ICAI, the assessing officer is required to examine impact of IGST on the profit for the year under assessment since IGST is of recoverable nature. Where the assessee follows the exclusive method of accounting and claims reversal of Input tax credit of GST, the AO is required to examine whether such reversal of input credit of GST is allowable expenditure in view of the provisions of Section 43B of the Income-tax Act, 1961. However, the final conclusion would be based upon the appreciation of individual facts of the case.

6.10 Green Plot and its Implications: The increasing waste and its improper management are one of the crises that countries across the world are facing these days. Like any other industry, the ship breaking industry, indeed world's biggest polluters, also creates a huge amount of waste every day. Therefore, in order to reduce the risks and impacts on workers and the environment of unsafe dismantling practices & to provide safe storage, transport, and disposal options for hazardous materials derived from the recycling process have given rise to a new term–green ship recycling. International Maritime Organisation's Hong Kong International Convention for the Safe and Environmentally Sound Recycling of Ships, 2009 also strictly directed that vessels that are being recycled after their service life should not pose any unnecessary risks to human health, safety and to the environment. Due to environmental norms, nowadays, Fleet owners such as M/s Maersk Line are seeking out recyclers that have the capacity to recycle their ships at safe and environmentally responsible facilities. M/s Maersk does so by writing specific Clauses into contracts with the intended buyers. In lieu of that M/s Maersk Line grants some financial relaxation to the buyer in the price but the buyer needs to go through a separate, rigorous audit carried out by Maersk for compliance. The price relaxation, thus increase the profitability of the ship breaker but on the other hand increase the total time taken in dismantling process. The AO need to carefully consider these factors as the ship breakers may suppress the extra profit generated through green Ship re-cycling process.

7. BYE LAWS OF GUJARAT MARITIME BOARD

Gujarat Maritime Board (GMB) grants permission to ship breakers to use the ship breaking plots. Thus, permission is of user only, and is subject to numerous terms and conditions, including payment of various charges. The ship breakers have no ownership right on the plots, whatsoever. The GMB charges Rs. 135 per unit of LDT for first year as recycling charges. Further, GMB charges certain amounts for any change in constitution of partnership, change in profit sharing ratios of the partners, etc. Such charges vary from Rs. 50,000/- to Rs. 2,00,000/- Gist of some other financial provisions are as mentioned in the Annexure-4.

8. COMMERCIAL CATEGORIZATION OF SHIPS

The recovery of ferrous/ non-ferrous metals, i.e. percentage yield depends to a very large extent on the type of ship being cut. Usually bulk oil tankers, ore carriers, military vessels, etc. give higher yields. The various types of ships brought for dismantling is being given in the Annexure-5.

9. Shipping Terms: Some of the shipping terms generally used in ship breaking industry is being given in the Annexure-6.

10. Proforma of some important documents

10.1 Letter of Credit—As per Annexure-7

10.2 Stock statement—As per Annexure-8

10.3 Physical delivery certificate—As per Annexure-9

10.4 Commercial Invoice—As per Annexure-10

11. CASE STUDIES

11.1 In a search in the case of a ship-breaking firm, it was found that the permission to utilize ship-breaking plot of Gujarat Maritime Board, was transferred by an outgoing concern to the assessee. It was found that while the full consideration was approximately Rs. 3 Crores, only about 20% or approximately Rs. 60 lacs was disclosed in the books of accounts. The balance amount changed hands out of books. Similar transactions are taking place in which only part of the consideration is disclosed. Several instances have come to light where no payment is shown to have been made against transfer of the ship-breaking plot. The disclosed transaction would only show that plant and machinery, building etc. are transferred at book value. However, no amount is disclosed against transfer of the right to use the ship-breaking plot.

11.2 In another case, it was found that the assessee had opened bank accounts in the names of several persons, including some employees. Through these bank accounts, he would first introduce cash, and then advance loans to his firm as and when required. Some of the parties were small time traders who purchased scrap from Alang and sold in the open market. Some of the names were altogether fictitious and could not be found on the given addresses. The assessee was asked to produce these parties. Naturally, some of the parties could not be produced even after giving a number of opportunities. Some parties were produced, but it was clearly established during the course of their examination on oath that they did not have the capacity to introduce lacs of rupees in their bank account, and to advance these to the assessee. The AO could, therefore, probe the probability of substantial addition *u/s* 68 of the Act.

11.3 In another case, the assessee had disclosed sale of certain quantity of furnace oil, diesel oil that appeared to be on the lower side. The AO examined the "Bills of Entry" in respect of all ships beached during the year. After the ship is beached and before permission to start cutting is given to the ship breaker, he has to certify that all oil has been evacuated from the ship. Since the assessees does not have any storage facility of oil, it can be safely inferred that by the time the ship breaker certifies that all oil has been emptied, the entire quantity is sold. From the 'Bill of Entry', the quantity of oil received year-wise was available. However, in this case it was found that the assessee had disclosed sale of only 50% of the total oil receipts.

11.4 Conclusion: While investigating the cases pertaining to ship breaking the A O should familiarize himself/ herself with the technical terms of the industry and the prevalent by laws of Maritime board. The AO should also be careful to study the type of ship dismantled during the relevant period. Needless to emphasize, the rules of GST, e-way bill, customs and labour laws will also play a major role in deciding the outcome of the investigation.

Annexure–1
Recovery of Ferrous and Non-ferrous Metals in Ship-breaking

S. N.	Metallic Recoveries	Percentage Range
1	Reusable Steel Plates	0–5
2	Rerollable Scrap	60–70
3	Heavy Melting Scrap	5–10
4	Cast Iron Scrap	2–5
5	Non-ferrous Scrap	0.5–1
6	Nonmetallic Component (including wood)	3–5
7	Non Recoverable	10–15

(*Source:* Report of August 1997 of MECON, Ranchi, on 'Present State of Ship Breaking in India', Ferrous Scrap Committee, Ministry of Steel, Government of India)

Annexure–2
Ship-breaking Yards with Specialization

S. N.	Ship Breaking Method	Ship Breaking Yards
1	Beaching the vessel bow forward during high tides with full force of the engine.	Alang, Sachana and Vishakapatnam
2	Mooring vessel along quay (berthing)	Mumbai
3	Mooring vessel along quay (berthing) and dry docking	Kolkata

Annexure–3
Main Equipments Used in Ship Breaking

Activity	Main Equipments
Preparation for breaking-up	Oil Pump, Boiler, Cutting equipment
Breaking down to big blocks	Floating crane, Tug boat, Rope carrying boat, Cutting equipment
Breaking down to medium/ small sections	Gantry crane, Crawler crane, Hydraulic shovel with fork grip, Cutting equipment
Breaking down to members and pieces	Gantry crane, Crawler crane, Cutting equipment
Product delivery	Forklift truck, Hydraulic shovel with fork grip, Dumper truck, Truck Weigh scale

Annexure–4

Gist of Various Charges/ Fees as per the Gujarat Government Gazette EX., 19-01-2016

a. Application money of Rs. 5 lakhs per plot is to be paid.

b. The amount of Security deposit is Rs. 5 lakhs per plot.

c. An annual development charges also needs to be paid to the GMB @ Rs. 2,700/- per Sq. meter and will be escalated by 10% every three years.

d. An annual Plot rent is payable @ of Rs. 80/- per Sq. meter per annum.

e. The ship breaker has to pay to GMB, LDT charges @ Rs. 12/- per ton of ship broken. He is bound to bring at least 30000 LDT of ships in each block of three consecutive financial years.

f. Dismantling permission shall be granted for ten financial years.

g. The plot cannot be used for any purpose other than ship breaking. Also any person other than the ship breaker who has been so permitted cannot use it.

h. Separate permission needs to be taken for dismantling each ship, after oil and lubricants have been unloaded from the ship.

Annexure–5

Various Types of Ships Brought for Dismantling

Ship Types	**Basic Groupings**
Liquefied gas tankers	Liquid gas
Chemical tankers	Chemicals
Oil tankers	Oil
Molasses and, water tankers	Other liquids
Bulk carriers, ore carriers	Bulk dry
Bulk oil carrier, ore carriers	Bulk dry/ oil
Self-discharging bulk carriers	Self-discharging bulk dry
Cement, wood chips, urea carriers	Other bulk dry
General cargo palletised cargo ships	General cargo
Container ships	Container
Refrigerated cargo ships	Refrigerated cargo
Ro-ro cargo ships Container/ ro-ro cargo ships Vehicles carriers Landing crafts	Ro-ro cargo
Passenger/ ro-ro cargo ships Passenger/ landing crafts	Passenger/ ro-ro cargo
Passenger ships	Passenger
Livestock carriers, Barge carriers, Heavy cargo carriers	Other fishing
Trawlers, fishing vessels	Fish catching
Fish factory ships and carriers etc..	Other fishing
Offshore support, drilling, well-production ships	Other offshore
Research ships	Research
Tugs, Pusher tugs	Towing/ pushing
Dredgers, Hopper dredgers	Dredging
Motor hoppers, sludge disposal vessels, crane ships, cable ships, icebreakers etc.	Other activities
Barges, pontoons, moored oil processing ships, moored cement handling ships etc.	Non-propelled ships
Yachts, sail training ships, naval auxiliary ships etc.	Other ships structures

Annexure–6

Some of the Shipping Terms Generally used in Ship-breaking Activity is given below:

Light Displacement Tonnage	:	The weight of a ship without stores, bunker fuel or cargo.
Ballast	:	Water or solids like cement is used as ballast to keep the vessel steady.
Bunker Tank	:	Ship-space for storing fuel (coal, oil, etc.)
Classification	:	Seagoing vessels of 100 GRT and more are built under supervision of one of the officially recognized classification societies, which have established rules and regulations. For example, Lloyd's Register of Shipping, London.
Starboard side	:	Right side of the ship.
Port side	:	Left side of the ship.
Draught/ Draft	:	The depth necessary to submerge a ship to her load line.
Bulkheads	:	To increase the safety of ship, it is divided into watertight compartments so that in the case of collision, the damage may be confined to one compartment.
Hull Insurance	:	The Hull insurance policy covers the hull, machinery and complete equipment of the ship.
Knot	:	A measure of speed, being one nautical mile of 6080 ft. Traversed in one hour.
Bonded goods	:	The goods deposited in a bonded warehouse until such time as the duty upon them has been paid.
Lien	:	The right of holding goods until debt in respect of such goods is satisfied.
Maritime Lien	:	Lien which travels with the ship even after change of it's ownership.
Bill of sale	:	A statutory document showing transfer of ownership of vessel.
Rummaging	:	The search off a ship by customs for smuggled or prohibited goods.
Laid-up ship	:	A ship which is not in use, put in a safe anchorage with a view to activate it in future either for trading or scrapping.

Annexure–7

Typical Letter of Cedit Opened by a Ship Breaker is in the following Format: Non-negotiable

Telex message no.

message from State bank of Saurashtra Darbargadh branch

Bhavnagar India

for SBI Frankfurt

: test non-negotiable for USD dated

opened our letter of credit no. dated for an amount not exceeding USD
favouring for account of for 180 days usance (hereinafter referred as 'beneficiary') non-negotiable (hereinafter referred as 'applicant') and available by

beneficiary's signed draft for maximum period of 180 days usance from the date of physical delivery and opening bank for 100 per cent invoice value for delivery of old ship M.V. ex

for demolition purpose at Alang district Bhavnagar India. Draft must state drawn under our letter of credit no. dated of stop drafts to be accompanied by the following documents in English.

1. Additional draft for USD for maximum period of 180 days usance drawn on applicant being total purchase price of old ship M.V.

1a. Separate drafts drawn on applicant for maximum period of 180 days usance along with invoice for USD being 7.5 per cent per annum interest amount for maximum 180 days usance from the date of physical delivery, or at the prime rate of USA prevailing on the date of negotiation, whichever is lower, as per MA dated _____. This amount is in addition to the L/C amount and to be claimed on due date.

1b. Signed commercial invoice in sextuplicate certifying the details of the vessel as described below and purchase price USD _____ as per MA dated _____ and to mention L/ C number.

Description as under

Name (mention ex-names also)	:
Type	:
Built (year and country)	:
Name of shipbuilder	:
Converted (lengthened)	:
Conversion year	:
Flag and port of registry	:
GRT/ NRT	:
Original LDT	:
Present LDT excl	:
Permanent ballast	:
Length (registered)	:
Breadth	:
Light draft	:
Working propeller	:
Spare propeller	:
Spare tail shaft	:
Main engine	:
Auxiliaries/ generations	:
Ballast tanks	:
Insulation	:
Construction	:

2. Notarized/ legal bill of sale in favour of the applicant certifying that the vessel is free from all encumbrances maritime liens and any other debts whatsoever duly signed under beneficiary's common stamps, dated and attested by notary public in Hamburg and/ or legalised by the Indian consulate in Hamburg. The full name and designation of the signatories to the bill of sale should be clearly specified on the bill of sale.

3. Original trim and stability book or capacity plan or letter from builders/ builders' successors substantiating the light weight or light ship displacement of the vessel as _____ metric tonnes or _____ long tons excluding permanent ballast.

4. Certificate from the beneficiary certifying that the vessel at the time of delivery is free from all encumbrances maritime liens and any other debts and liabilities of any description whatsoever, and indemnifying the applicant against the consequences of any claim which have been incurred prior to the time of delivery of the vessel.

5. Original certificate from registration authorities of the vessel's present port of registry with their seal and stamps and signed manually in original by concerned port authorities in the name of the former owners certifying that the vessel_____ is free from all encumbrances, mortgages, maritime liens and debts on the vessel at the time of delivery of the vessel to the applicants. This certificate must not be dated more than seven days prior to the date of negotiation of documents.

6. Photocopy of bill of sale from the registered owners to _____ deleting the purchase price.

7. Certificate from the negotiating bank certifying that they have paid the full purchase price of the vessel _____ to the owner of the vessel as shown in the registration certificate.

8. Copy of the beneficiary's telegram/ telex/ fax sent by beneficiary registered as owner in the port of registry to the master of the vessel incorporating delivery instructions to deliver the vessel _____ physically to the applicant or their nominated representative on 'as is where is' basis at Alang anchorage not before _____ but not later than _____ unless extension of delivery date is mutually agreed on condition as she is safely afloat port worthy, virtually intact, free of fire damage, free of arms and ammunitions, free of hull leakage, free of cargo, charter fee, having all her anchors in working condition and under her own power during business hours of a working day, with repeat message to the applications.

9. Letter of undertaking from the beneficiaries guaranteeing that they will submit to the applicant a deletion certificate from the authorities of the vessel's port of registry as soon as possible but not later than months from the date of delivery.

10. A tested telex/ cable from opening bank confirming that the applicant have received the notice of readiness from the beneficiaries' agent in Alang and that the vessel has been physically delivered safely afloat at Alang anchorage.

11. Certificate from applicant that the vessel has been successfully beached at plot no. _____ at Alang.

Special Instructions

1. All bank charges outside India are for beneficiary's account including L/C advising charges of L/C advising bank, whether L/C is Utilised or not.

2. Last date of delivery under this credit is _____ and of negotiation is _____.

Instructions to the Negotiating Bank

1. They should invariably confirm prime rate prevailing on the date of negotiations of documents.

2. They should forward to opening bank the drafts and the original documents by the quickest possible means i.e. international air courier service on the date of negotiations itself.

3. Please advise opening bank by urgent telex at no. _____ or by cable addressed to branch, _____, India receipt of documents in conformity with the letter or credit terms.

4. The negotiating bank should obtain reimbursement on due date as confirmed by opening bank from _____ certifying therein that the terms and conditions of the credit have been complied with.

5. Negotiating bank to negotiate/ discount documents for USD _____ only of the invoice/ draft amount and balance of USD _____ to be released by negotiating bank only if tested telex message within seven days of negotiation is sent by opening bank to negotiating bank confirming successful beaching of the vessel _____ at plot no. _____ at Alang and also confirming receipt of certificate of Lloyd's approved agent duly counter signed by the applicant and Notarized by public notary in Bhavnagar certifying therein all the details of vessel _____ as described

in Clause 1b of this letter of credit. The surveyors will also specifically confirm light displacement tonnage excluding permanent ballast and weight and material of propeller and tail shaft of the vessel. This is an operative instrument and no mail confirmation will follow. Please advise the beneficiary accordingly. Please note that L/C advising charges, if any, to be paid by beneficiary whether the L/C is Utilised or not. We hereby engage with drawer's endorsers and bonfire holders of the drafts drawn under and in compliance with the terms of this credit that such drafts shall be duly honoured on presentation and delivery of documents as specified above. Except as otherwise expressly stated this credit is subject to the uniform customs and practice for documentary credits (1993 revision) International Chamber of Commerce publication no. 500.

Annexure–8

A Typical Proforma of Fortnightly Stock Statement Given by a Ship Breaker to his Bankers, is as Under:

State Bank of Saurashtra, Darbargadh branch, Bhavnagar

Fortnightly Stock statement as on _____ M/s

PART–I

(a)	Name	:	M.V.
(b)	C.C. a/c no.	:	
(c)	Import price	:	
(d)	Total import price	:	
(e)	Usance interest	:	
(f)	Total import price with usance interest	:	
(g)	Conversion rate	:	
(h)	Total import price with usance int.	:	
(i)	Other landing expenses		
	a.Custom	:	
	b.Excise	:	
	c. Port charges	:	
	d. Insurance premium	:	
	e. Beaching charges	:	
	f. Other (bank charges)	:	
	total	:	
(j)	total landed cost. (h + i)	:	
	(Rs. per M.T.)		
(k)	Average landed cost	:	
(l)	Average cutting cost per LDT/ M.T.	:	
(m)	Average total cost of broken Stock	:	

PART–II UNBROKEN STOCK

M.T.

(a) Stock as on last fortnight :
(b) Stock broken during the fortnight :
(c) Stock as on the date of statement.
(a-b)
(d) Value of Stock as on the date of statement :

PART–II A SEMI-BROKEN STOCK

(a) Stock as on last fortnight :
(b) Stock broken during the fortnight :
(c) Total semifinished Stock :
(d) Goods finished :
(e) Stock of semi finished goods :

PART–III BROKEN STOCK

(a) Stock as on last fortnight :
(b) Stock broken during fortnight :
(Part II (b) less 10% cutting loss)
(c) Total broken Stock (a + b) :
(d) Stock sold during fortnight :
(e) Stock as on the date of statement :
(c-d)
(f) Value of the broken Stock :

PART–IV: TOTAL STOCK/ RECEIVABLES

(a) Total unbroken stock (Part-III)
(b) Total broken stock (Part III)
(b-1) Total semi finish stock (Part II-a) :
(c) Total stock (a + b) :
(d) Receivables :
(e) Total stock & receivables (c + d)
F.D.R. :
L.C. :
TOTAL :

PART–V PROGRESSIVE REPORT

Sales
(a) Sales upto last fortnight :
(b) Sales during this fortnight :
(c) Total Sales upto this fortnight :

(d)	Book-debts as on last fortnight	:
(e)	Gross addition to book-debts during fortnight	:
(f)	Total book-debts. (d + e)	:
(g)	Book-debts realised during fortnight	:
(h)	Book-debts as on this fortnight	:
(i)	Deposit in CC/ TDR/ CD out of sales	:

Certified that the details mentioned as above reflect the true and correct position obtained from out of books of accounts. We also certify that the assets shown above are exclusively of our ownership and no any other persons/ institute has any interest, line or charge thereon.

Date: Authorised Signatory

(for bank's use only)

Received on verified on entered on signature

Remark if any:

(1) Credit received upto last fortnight Rs.

(2) Credit received during the fortnight Rs.

(3) Total credit received upto fortnight Rs.

Annexure–9

A typical physical delivery certificate issued by the Master of Ship, while handing over possession of the ship to the ship breaker is in the following format:

I, _____ Master of the vessel M.V./ _____ do hereby physically deliver the said vessel at ALANG Anchorage at _____ hours on _____. The vessel is delivered safely afloat port worthy virtually intact charter free, free of cargo, free of hull/ stern gland leakage seepage, free of fire damage, free of arms and ammunitions, having both her anchors in working condition and under her own Power/ tow. The vessel is delivered with everything on board including _____ working propeller, _____ spare propeller _____ spare Tail Shaft/ but excluding the personal effects of Master, Officers and crew and any Items on Hire.

As per the terms of the relevant MA between Buyers and the Sellers for M.V./ M.T. _____ _____ and under Instructions from the Sellers the vessel is hereby delivered to M/s. _____ _____ _____ represented by Mr. _____ to whom I am also handing over all classification certificate and/ or copies for hull, engines anchors etc.. including ship's Registry Book.

I, hereby confirm that the undersigned and Officers/ Crew of the vessel do not have any outstanding dues on the vessel.

For _____ **SHIPPING SERVICES PVT. LTD. (as seller's agents)**

MASTER

Taken delivery of M.V. _____ at _____ hours on _____ at ALANG/ ANCHORAGE at ALANG.

(Sd/-)

_____

Annexure–10

LETTER HEAD OF FOREIGN SUPPLIER

DATE: INVOICE NO.

PLOT NO. _____ SRY, ALANG,

DIST. BHAVNAGAR,

GUJARAT, INDIA.

COMMERCIAL INVOICE

WE CERTIFY THE DETAILS OF THE VESSEL AS DESCRIBED IN THE FIELD 45A AND STATING TOTAL PURCHASE PRICE IN WORDS AND FIGURES USD (US DOLLARS_____

_____)(INTERESTFREE)ASPERMOADATED_____,

2016 AND ADDENDUM 01 DTD. _____ L/C NO. _____.

45A: DESCRIPTION OF GOODS OR SERVICES DESCRIPTION OF THE VESSEL

NAME: _____

EX. NAME:_____

TYPE:_____

BUILT: _____

FLAG: _____

IMO NUMBER: _____

LIGHTWEIGHT: _____

WORKING PROPELLER: _____

DELIVERY: _____,

ANY ADDITIONAL GENERATOR, EMERGENCY GENERATOR OR ANCHOR, STORES AND SPARES, SPARE PROPELLER BLADE OR SPARE PROPELLER, SPARE TAILSHAFT, ANY

PERMANENT BALLAST, ANY CONTAINER, ANY PONTOON, LASHING MATERIAL, BUNKER THOUGH NOT MENTIONED IN MEMORANDUM OF AGREEMENT BUT FOUND ON BOARD WILL BE BUYER'S PROPERTY, WHICH IS INCLUDED IN THE COST OF SHIP.

L/C NO. DATED

..... Director

CHAPTER

13

Road Transport

1. INTRODUCTION

Road transport is a dominant mode of transport in India, both in terms of traffic share and in terms of contribution to the national economy. Apart from facilitating the movement of goods and passengers, road transport plays a key role in promoting equitable socio-economic development across regions of the country. Easy accessibility, flexibility of operation, door-to-door service and reliability have earned road transport greater significance in both passenger and freight traffic vis-à-vis other modes of transport. India has one of the largest road networks of over 56.17 lakh km comprising National Highways, Expressways, State Highways, Major District Roads, Other District Roads and Village Roads. The table below shows the length distribution of road network in India:

2. The economic impact of roads on the GDP of any country is immense. Higher the density of National Highways, higher is the Interstate Trade (Export + Import) as a percentage of Gross State Domestic Product (GSDP) in Indian States (Figures-A & B). A positive relationship

Road Network	Length (km)
National Highways/ Express Way	1,15,530
Satate Highways*	1,76,166
Other Roads*	53,26,166
Total	56,17,812

Source: Ministry of Road Transport and Highways
Note: *As on 2015–16

exists between density of NHs and the per capita income in Indian States. Higher the density of National Highways, higher is the per capita GSDP. Roads continue to constitute a significant component of India's logistics industry, accounting for 60 per cent of the total freight movement. Rapid progress in augmenting road infrastructure in recent years is leading to efficient usage of road transport, given its ability to facilitate last mile connectivity and integrate various modes of transportation. India's road freight market is valued at $150 billion and is growing at a CAGR of 12%. Major players in this business include such marquee names as Transport Corporation of India Ltd., Gati Infrastructure Pvt. Ltd., Sical Logistics Ltd., Best Roadways Ltd. and All Cargo Logistics.

3. STRUCTURE OF ROAD TRANSPORT BBUSINESS

3.1 Usually, a large-scale transport operator has his own fleet of lorries. He may also hire lorries from others for carrying goods, when the business so demands. He also has a specified number of routes on which he is permitted to carry the goods. Branch offices or agents are located along these routes for attending to booking and delivery of consignments from and to different places. The hierarchy of offices may comprise the Booking-cum-Delivery offices, Regional offices (variously known as Zonal office, Divisional office etc.) and the Head office.

3.2 The business of road transport begins at the 'Booking-cum-Delivery Office'. These are usually small offices and may be located in metros as well as in small towns. Wherever there

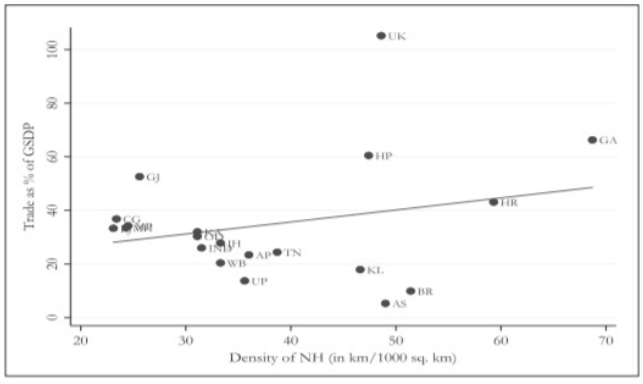


Figure-A
Density of NHs and Trade as per cent of GSDP

Source: Ministry of Road Transport and Highways

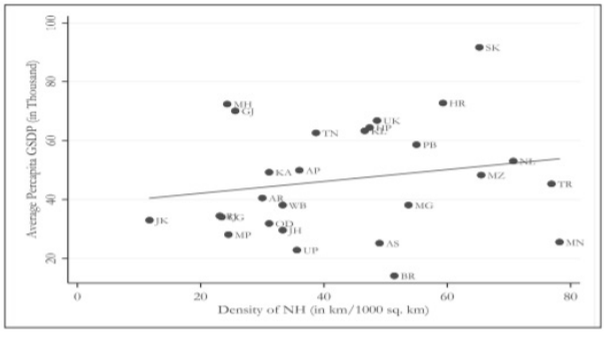


Figure-B
Relation between Density of NHs and per capita GSDP

Source: Ministry of Road Transport and Highways

is no branch of the operator, there may be an arrangement for booking and delivery through a local agent. The 'Booking-cum-Delivery Office' accepts consignments from consignors for transport to different destinations. It also receives consignments from other stations for delivery to consignees. A booking office may be a local branch office or it could also be a regional or a higher-level office in the hierarchy. A booking office may transport goods on its own or may send the consignments to a nodal centre for transportation in a consolidated manner. It is imperative for the Assessing Officer to understand the location and layout of various offices of the transporter as well as of the agents so as to understand the overall business operation and examine critical nodes of the network for ascertaining the likely tax evasion.

4. THE DOCUMENTS

4.1 Following documents are generally prepared at the 'Booking-cum-Delivery Office':

a. **The Consignment Note:** It is prepared in multiple copies, one each for the consignor, the consignee, the controlling office of the booking office, the destination office, and one copy for the driver to carry en-route.

b. **The Lorry Hire Contract:** It is a very important document and contains details of the contract between the transporter and the owner of the lorry being hired. It contains information like lorry number, starting station and destination station, number of packages loaded, weight of the consignments loaded, the rate of hire agreed upon, the total hire to be paid, advance hire paid to the driver, details of fuel filled, etc.

c. **Lorry Challan:** It is another important document prepared at the booking office. It is prepared for each lorry engaged to carry goods, and contains details of consignments carried on that particular lorry.

d. **Vouchers:** These are prepared for local lorry hire expenses and also relate to hire charges incurred for engaging local lorries to pick up consignments from consignors' doorstep or to make door delivery of consignments at the destination station.

e. **Vouchers for Other Expenses** are prepared to vouch for expenses that may be incurred by a booking office on office maintenance, stationery, telephones, petty cash expenses, etc.

4.2 It is likely in some cases that the booking office may not maintain elaborate accounts of transactions and instead may send periodical statements or reports to its controlling regional office. Usually a statement of income and expenditure along with supporting vouchers is sent periodically.

4.3 E-way Billing: E-way Bill is an Electronic Way Bill for movement of goods to be generated on the E-way Bill Portal. A person registered for GST cannot transport goods in a vehicle whose value exceeds Rs. 50,000 or the applicable amount (Single Invoice/ bill/ delivery challan) without an E-way bill that is generated on https://ewaybillgst.gov.in/. Alternatively, E-way bill can also be generated or cancelled through SMS, Android App and by site-to-site integration through API. When an E-way bill is generated, a unique E-way Bill Number (EBN) is allocated and is available to the supplier, recipient, and the transporter. Unregistered persons are also required to generate E-way Bill. However, where a supply is made by an unregistered person to a registered person, the receiver will have to ensure that all the compliances are met as if they were the suppliers. Transporters carrying goods by road, air, rail, etc. also need to generate E-way Bill if the supplier has not generated an E-Way Bill.

5. EXAMINATION OF ACCOUNTS

5.1 The *modus operandi* of tax evasion in the case of road transport operators does not differ

from that of other assessees, as they can also resort to suppression of receipts and inflation of expenses. The specific method followed to conceal income, however, varies from case to case and requires a clear understanding of the business set-up, nature of transactions at various stages and knowledge about the business practice followed by the consignors. The investigation in such cases may result in unearthing tax evasion and a sustained and patient examination of the various registers maintained can also lead to finding concealment relating to purchases, sale, stock in the cases of the consignors, consignees and such related parties.

5.2 As already mentioned, a transporter operates through many branch offices. Expenses under major heads are incurred at the booking offices. The freight receipts are also collected at the booking office. Since the management is not directly connected with collection of receipts and giving out cash for expenditure, it has to necessarily depend on its lower level employees at branch level offices to siphon off cash by inflating expenses or by suppressing income. Thus, for a big transport operator with branches spread over different parts of the country, the siphoning off of cash can take place only at a few selected offices through a few trusted employees. It should be kept in mind that large scale operations have strict internal checks and balances to keep the employees in control and the management would have a regular reporting mechanism of its own. If such documentation is detected during the course of search/ survey operations, it may yield good insight into tax evasion.

5.3 The examination of accounts and line of investigation depends on the fact whether the assessee owns or hires the vehicles used for transportation or has a mix of both. This fact needs to be ascertained before commencing detailed investigation as this would determine the focus of investigation.

6. SUPPRESSION OF FREIGHT RECEIPTS

6.1 In some cases, there may be strong reason to suspect suppression of freight receipts. This is more likely to happen in case of cash receipts. Unlike inflation of expenses, suppression of receipts does not require fabrication of evidence. Rather, it requires destruction or concealment of evidence. This requires the Assessing Officer to take recourse to indirect means to establish the suppression.

6.2 Under the Motor Vehicles Act, 1988 every commercial motor owner is under a statutory obligation to maintain a 'Good Vehicle Record', wherein day-to-day details of the movement of the vehicle and cargo carried by it are entered. Besides, the assessee itself may maintain similar record (like 'Trip Account Sheet') for monitoring expenses incurred in respect of each of its own vehicles. These records contain details of the movements of the vehicle and the freight carried by it. In addition, there is also another important document, called 'Challan'/ 'Bilti', carried by the lorry driver or the conductor, which records the details of the goods carried on that particular trip. These records can be used to verify whether all trips and the connected freight receipts have been properly accounted for in the books of account of the assessee.

6.3 The 'Trip Account Sheet' and other similar record maintained by the assessee will have full information of the lorry's trips and also consumption of fuel. Even kilometre readings at the start and end of a trip are noted. From the distance covered by a lorry and the standard freight rate per tonne per kilometre, it is possible to work out the freight earnings by a particular lorry during a given year which can be compared with the receipts shown in the books of account. Claims of empty return trips can also be verified from the trip sheets. The assessee may also be called upon to furnish party-wise and lorry-wise earnings. Party-wise earnings may be cross verified with the parties concerned and lorry-wise earnings can be checked to see if they are

commensurate with the distance run by the lorry. The AO may also examine the suppression of income from passengers/ goods on empty return trips.

7. INFLATION OF EXPENSES

Major issues where there is a likelihood of inflation of expenses are as follows:

7.1 Lorry Hire Charges: In the case of the business being run on hired vehicles, a major item of expenditure is the lorry hire charges paid to third parties. There may be two types of lorry hire charges paid; the assessee may be hiring lorries for carrying goods from one station to another station or for local pick-ups and door delivery. The records maintained are likely to be different for both kinds of hire charges. Local lorry hire charges are petty amounts, normally paid in cash and supported by the assessee's self-made vouchers. Hire charges for long distance hiring are normally of large amounts and are based on the lorry hire contract, which is prepared in multiple copies. However, in a small operator's case such elaborate documentation may not be available as these are oral agreements. Wherever possible, party-wise and lorry-wise details of the hire charges paid must be obtained and cross verified with the lorry owners. If the assessee's records are not computerised, these details can be got computerised and then analysed party-wise and lorry-wise. The lorry numbers must be got verified with the Road Transport authorities and/ or website vahan.nic.in. It may, sometimes, emerge that hire charges are claimed to have been paid for non-existent lorries, or for lorries that were never at the place from where they are claimed to have carried the goods for the assessee. It may be also found that the same lorry is claimed to have plied to different destinations (say, from Nagpur to Chennai and also to New Delhi) on the same date. Such evidence will establish that the assessee is booking bogus hire charges.

7.2 Tyres and Tubes Expenses: This is another major item of expenditure, which can be inflated easily. Usually, the assessees have a system of monitoring use of tyres. After understanding the system followed, relevant information i.e. purchase details/ retreading details etc. may be cross verified with parties. In such circumstances, fictitious billing is also a possibility to be checked.

7.3 Fuel Expenses: The assessee may be inflating expenditure on fuel consumed also. Most purchases are likely to be from one or a few petrol pumps on a regular basis. It should be possible to work out the average fuel consumption by the assessee's lorries from their trip sheets. Abnormally high consumption of fuel should always be examined in-depth. The average fuel consumption can be verified from the websites of the vehicles manufacturers.

7.4 Other Expenses: Like repairs and maintenance, salaries, advertisement, loading/ unloading etc. may also require to be investigated in particular cases. Copy of accounts of third parties invariably be called for by issuing notices *u/s* 133(6) and summons/ commission and be cross-verified with the books of account of the assessee.

7.5 Bogus Depreciation Claim: In case of large fleet owners, depreciation claim on second hand vehicles must be verified. Investigation in several cases has revealed that as the vehicles age, the receipts are reduced to show low profit as there is a lesser depreciation claim.

7.6 Scrap Sale: Depreciation on commercial vehicle is always higher, and so the WDV reduces substantially after 4/ 5 years. Also, big transporters do not use old vehicles and keep selling vehicles as scrap. The scrap value should be checked as to whether it is reasonable or not. Sale value is to be reduced from the block of assets for correct depreciation claim.

8. ROAD TRANSPORTERS CATERING TO SHIPPING INDUSTRY

Transport of bulk or Container cargo from ports to destinations hinterland is a major part of the road transport operations. However, the nature of this activity is in many ways different from inland transporters. These transporters are closely connected with Shipping and Clearing/ Forwarding agents.

9. SHIPPING AGENTS

9.1 The functions of Shipping agents include canvassing for and managing the business of their Principals (i.e. the foreign ship owners/ Charterers) in India. They have to strive for maximising the freight/ cargo being carried on the ships of their Principals arriving at Indian ports. They provide services to the Principals' ships while in Indian ports and are responsible for loading and unloading of containers/ cargo on these ships. In turn, they engage various contractors for providing services, for example, transporters for handling the cargo inside the port, Stevedores for stuffing and destuffing the cargo, Chandlers for provisions supplied to the ships, etc. The agents collect the freight and make payments to these contractors. They receive agency commission for rendering these services. Shipping agents also undertake the work of handling the import/ export cargo of Indian importer/ exporter.

9.2 The accounting system followed by Shipping agents needs to be understood. The shipping agents receive the Gross freight, Terminal Handling charges (THC), and Inland Haulage charges (IHC) from the importers/ exporters referred to as the Shippers. The THC is fixed by the port authorities and includes transportation and handling charges for the containers inside the port and stevedoring charges for stuffing and destuffing of containers. The IHC is for transportation of containers from the Inland Container Depots (ICD) to the port of shipment.

9.3 All these receipts are credited to an account in the books of the agent called the "Vessel Voyage Collection Account". The payments to various contractors such as transporters, stevedores, and other payments towards inland haulage, freight rebate, and freight brokerage are debited to an account called the "Vessel Voyage Disbursement Account". These accounts are maintained vessel-wise and voyage-wise.

9.4 There are certain expenses not directly related to the voyage such as repair of the Principals' containers, which are directly debited to the Principal's general account. The only expense pertaining to the voyage, which can be debited after the remittance of the freight, is the ground rent charged by the Port Trust. One of the expenses debited to the "Vessel Voyage Disbursement Account" is the agency commission receivable by the agent, which is then credited to the agent's P&L a/c. Other receipts and payments from the Voyage accounts are not credited or debited to the P&L account of the agent. The balances of all accounts however appear in the Balance Sheet of the Agent. The Agent's P&L account, on the other hand, reflects receipt of agency commission and expenditure incurred in maintenance of staff and office etc.

9.5 Another charge collected by the Agent from the Shipper (importer/ exporter), on behalf of the Principal is called "Container Detention Charge" (CDC). This charge is collected at rates fixed by the Director General (Shipping), and Port Trusts. This is dependent on the number of days that the container remains within the port.

10. CONTAINER HANDLERS/ TRANSPORTERS

10.1 The shipping agents engage transporters/ container handlers for transportation within the Port area as well as for inland transport. Often, the transporters, in return for the contracts received, pay cash kickbacks/ commission to the Shipping agents. Container handlers by the very nature of the services provided couldn't have

unaccounted receipts except in one specific function 'cash cartage', discussed later. They have to account for their receipts because the Shipping agent who is making payment to them is doing it on behalf of its Principal, and each and every payment has to be accounted for. Moreover, it is a deductible expense for the shipper, and he in turn requires bills for the same. Hence, to generate the required cash for paying cash commissions to the Shipping agent, the transporter has to book bogus expenses. The rates fixed between Shipping agents (on behalf of the Principal), and the transporters are exorbitant, primarily because the commissions that the agent expects to receive are built into these. Searches in the case of prominent transporters brought out evidence showing that bogus expenses were claimed under different heads on account of spare part and repairs, tyres and petrol & diesel.

10.2 Spare parts and repairs are the easiest area where bogus expenditure can be introduced. False vouchers are readily available through brokers and in return for cheques issued, cash is handed back on payment of a small commission. The AOs conducting enquiries in such cases should trace the route of such cheques issued in the names of parties who appear bogus especially those, which appear as sundry creditors from year to year.

10.3 These transporters consume specialised tyres, such as 1000/ 20 tyres, the bills for which are normally received from registered dealers of major tyre manufacturers. The dealer cannot normally issue bogus bills since the discrepancy can be easily detected on verification of his Stock register and his purchase bills. In one case, documentary evidence was found which showed that the dealer was giving bills to the assessee in respect of tyres sold to other parties who had made cash purchases and had not taken bills. However, without documentary evidence it shall be difficult to prove such a transaction. The AOs should scrutinise the books for payments made to unregistered dealers for purchase of tyres.

10.4 Cash Cartage: Another area of concealment detected in the cases of such transporters, pertains to suppression of cash cartage receipts. Cash cartage refers to receipts of cartage in cash at the Container Freight Stations (CFS) in the port area for loading and unloading of containers. The main business of these transporters is movement and handling of containers inside the Port area. They receive stuffed export containers after custom examination, at pre-designated points called CFS. The transporter is required to load the containers on to his trailer at the CFS, and then to carry it from point to point inside the Port like the stack point, storage yard, hook point, etc., for various purposes, and finally to load these on the ship. For this, they utilise their trailers, forklifts, cranes and top-lifters etc.

10.4.1 This cartage is received at a fixed rate per 20 ft container, as fixed by transporters. The rationale behind such charges, according to the transporters, is that their contracts with the Shipping agents cover movement of containers inside the Port area upto unloading of import containers and loading of export containers at the CFS. This extra loading/ unloading of some containers at the CFS is not covered by the contract. Moreover, although the CFS is in the Port area it is deemed to be outside it and the contract with the Shipping agent is only for movement inside the Port area. This cartage is received in cash by the transporters from the exporters and importers or their Clearing agents.

10.4.2 The Clearing agents who handle such movement in the CFS always make payments in cash because they submit a lump sum bill to their customers i.e. Importers/ Exporters, covering all services rendered. No supporting bills are given and in turn the Clearing agents withdraw cash and make cash payments. Since a major part of their expenses are "speed money" paid in the Port area and Custom house, they prefer such a system. In a search case, documentary evidence in the form of diaries indicating actual receipts were found in the possession of the Supervisor

in charge of their Port operations, showing that only 1/ 3 rd of such receipts were being accounted.

11. Road Transporters Catering to Air Cargo Industry: Similar to shipping agents, the air cargo agents or handling agents manage the business of Airlines who handle air cargo in India. They are responsible for loading and unloading and transporting the cargo from its source to airport and vice versa. While scrutinizing the transporters, the Assessing Officer may cross verify the books of accounts of agents debiting the transportation cost to detect any probable suppression.

12. End to End Logistics: Recently, the end to end logistics providers are increasing wherein they provide the services like packing the customer products, transporting the products from one place to another, advertising the products by creating the stalls in the shopping malls, etc. for the specific customers. These end to end logistics provider engage transporters for moving the customer's goods. While examining the cases of road transporters, the Assessing Officers should also collect information relating to end to end logistics provider to whom they are catering and also to cross verify the same with the Assessing Officers of the Principals for detection of tax evasion in the case of logistic providers as well as the Principals. Mostly the logistics providers will incur cash expenses to engage various transporters and book their expenses and these details should be collected while assessing transporters to detect any possible evasion.

13. PROVISIONS OF THE ACT RELATED TO ROAD TRANSPORTERS

The Income-tax Act addresses the peculiarities of the road transport business and provides for the following provisions specifically to enable the conduct of this business.

13.1 Section-44AE: Special provision for computing profits and gains of business of plying, hiring or leasing goods carriages

(2) *For the purposes of sub-section (1), the profits and gains from each goods carriage:*

(i) *being a heavy goods vehicle, shall be an amount equal to one thousand rupees per ton of gross vehicle weight or unladen weight, as the case may be, for every month or part of a month during which the heavy goods vehicle is owned by the assessee in the previous year or an amount claimed to have been actually earned from such vehicle, whichever is higher;*

(ii) *other than heavy goods vehicle, shall be an amount equal to seven thousand five hundred rupees for every month or part of a month during which the goods carriage is owned by the assessee in the previous year or an amount claimed to have been actually earned from such goods carriage, whichever is higher.*

13.2 Section-40A: Expenses or Payments not Deductible in certain circumstances

(3) Where the assessee incurs any expenditure in respect of which a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft,[or use of electronic clearing system through a bank account, exceeds ten thousand rupees,] no deduction shall be allowed in respect of such expenditure.

…

Provided further that *in the case of payment made for plying, hiring or leasing goods carriages, the provisions of sub-sections (3) and (3A) shall have effect as if for the words "[ten] thousand rupees", the words "thirty-five thousand rupees" had been substituted.*

13.3 Section–194C: Payments to Contractors

194C. *(1) Any person responsible for paying any sum to any resident (hereafter in this Section referred to as the contractor) for carrying out any work (including supply of labour for carrying out any work) in pursuance of a contract between the contractor and a specified person shall, at the time of credit of such sum to the account of the contractor or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct an amount equal to:*

i. one per cent where the payment is being made or credit is being given to an individual or a Hindu undivided family;

ii. two per cent where the payment is being made or credit is being given to a person other than an individual or a Hindu undivided family,

of such sum as Income-tax on income comprised therein.

…

…

(6) No deduction shall be made from any sum credited or paid or likely to be credited or paid during the previous year to the account of a contractor during the course of business of plying, hiring or leasing goods carriages, where such contractor owns ten or less goods carriages at any time during the previous year ***and furnishes a declaration to that effect along with his Permanent Account Number****, to the person paying or crediting such sum.*

The Assessing Officer is advised to go through the statute and apply the provisions relating to the assessment year concerned.

14. CHECK SHEET FOR SCRUTINY

Following are the important points that should be investigated by the Assessing Officer while scrutinizing the business of road transporter:

a. To cross-check the registration details with RTO to verify whether registration numbers submitted are actually those of the goods carrying vehicles as sometimes even fake numbers or numbers of two-wheelers etc. are given. Further, it will also substantiate whether the vehicles shown are having All India permits or local permits.

b. Normally the road transporter has a well-established supply chain having several agents and entities spread across a wide geographical area, therefore, special attention should be paid to check the integrity and genuineness of the supply chain.

c. Besides issuing notices *u/s* 133(6), in-house verifications i.e. cross verification of details with jurisdictional Assessing Officers of sub-contracting parties can be also very fruitful.

d. Vouchers–substantial expenses involve cash payments and cash payments are made at various branch offices of the business. These expenses are generally supported by self-made vouchers more often than not without the signature of the person receiving the payment. These expenses should receive special attention of the investigator.

e. Details of TDS returns should be verified with the books of account. Even when the assessee does not deduct TDS, he needs to have a declaration from the person receiving the payment that TDS need not be deducted as per provisions of Section 194C or 197. The PANs provided should be verified to establish the genuineness.

f. This sector is unorganised and cash expenses are involved and there is a possibility of bogus billing. The Assessing Officer should cross verify the details by calling for information *u/s* 133(6) or issuing summons/ commission *u/s* 131.

g. Source of expenditure for statutory dues should be cross-verified with the books of account.

h. Reconciliation of the following documents:

(i) GST returns and ITR

(ii) E-way billing system with Trip Account Sheets

(iii) Tonnage–weighing station receipts (*the dharamkanta*)

(iv) Data of current year with that of previous year–the ratios clearly point to abnormalities in the way the business has changed from previous year to current year and lead the investigator to the places of possible manipulation and tinkering of accounts:

a. Branch/ booking office wise

b. Expenditure (heads such as repairs, spares, lorry hire, loading/ unloading etc.) wise

c. Fuel utilization

d. Client wise

e. Source/ Destination wise

f. Cash deposits/ cash withdrawals–across several offices

g. Toll charges

15. CASE STUDY

15.1 The assessee is a firm and is a road transporter with sales declared at more than Rs. 30 Crores. However, the Net Income offered to tax was only Rs. 30 Lakhs.

15.2 The low net profit was also a reason for selection of the case under CASS. After analysis of the expenditure pattern, it was discovered that most of the expenditure was towards lorry hire charges to small time lorry owners–the assessee was asked to submit cash book and ledger accounts of the various lorries which he hires.

15.3 Careful analysis of the cash book and ledgers revealed a pattern wherein cash payments were split to ensure that payments made to one party on a single day never exceeded Rs. 20,000/-. However, it was noticed that a party received split cash payments like Rs. 19,000/- on day-1, Rs. 18,000/- on day-2 and Rs. 19,000/- on day-3. The party did not receive any money for next 15 days and again a similar pattern of split payment spread across 3–4 days was noticed. This appeared a means to circumvent the provisions of Section 40A. The assessee was asked to produce vouchers for these payments. On being asked to produce vouchers, the assessee sought several adjournments and thereafter submitted photo copies of few vouchers. The vouchers did not appear genuine as most of them were unsigned and wherever signed, appeared that one person had signed all the vouchers as a receiver.

15.4 The assessee was, therefore, asked to produce vouchers in original which the assessee failed to do even after taking adjournments. Summons *u/s* 131 was issued to the partner of the assessee firm to produce original vouchers along with books of account. The assessee could not produce original vouchers but the Tally backup of the accounts was produced. The Tally backup accounts copy was seized.

15.5 The analysis of the accounts in Tally revealed that the photocopies of vouchers earlier submitted were not reflected in the account books. A simple test-check revealed that vouchers and Tally accounts could not be genuine at the same time. In view of this, the assessee was asked to show cause why books should not be rejected and net profit revised upwards. The assessee could not explain on what basis books of account were prepared and admitted that he had failed to maintain the books of account properly because of various agents and branch offices spread across multiple states. Consequentially, the Net profit was thereafter estimated upwards.

15.6 Further in many cases on analysis of cheque payment made to agents, it was noticed that the cheques were not account payee cheques and the assessees inflated the expenses by creating fictitious agents and were issuing bearer cheques in the names of fictitious agents. The Assessing Officer should, therefore, carefully verify the details of cheque payments also.

CHAPTER

14

Shipping Industry

1. INTRODUCTION

1.1 Industry Profile

Shipping is a global industry and its growth is a reflection of the level of economic activity. This is also the reason as to why the shipping market is cyclical in nature and freight rates generally tend to be volatile. Simply put, the freight rates and earnings of the shipping companies are primarily a function of demand and supply in the market. The demand side is driven by growth in trade as well as the geographical balance of trade (which determines the length of haulage required) while the supply side is driven by orders placed for new ship building as well as the scrapping of existing tonnage.

1.2 The global shipping industry can be broadly classified into wet bulk (like crude and petroleum products), dry bulk (like iron ore and coal) and liners (like containers and others). There are various benchmarks that monitor and publish freight rates for these segments. The prominent amongst them are Baltic Freight Index, Baltic Dry Index (for dry bulk segment) and Baltic Clean and Dirty Tanker Index (for tankers). The industry is regulated by the rules and regulations of International Maritime Organisation (IMO), International Association of Classification Societies (and also other similar classification societies) and the requirements of the concerned flag state where the ship is registered. Apart from these, there are also the rules and regulations of various countries where the vessel operates.

1.3 The Shipping Industry constitutes the backbone of Indian exports and imports accounting for almost 95% of the country's merchandise trade by volume and approximately 70% in terms of value. India has 12 major and 200 notified minor and intermediate ports. India is the sixteenth largest maritime country in the world, with a coastline of about 7,517 km. The Indian Government promotes the sector by allowing Foreign Direct Investment (FDI) of up to 100 per cent under the automatic route for port and harbour construction and maintenance projects. It provides a 10-year tax holiday to enterprises that develop, maintain and operate ports, inland waterways and inland ports. In FY 2016–17, the Indian Port sector witnessed a capacity growth of 1,065 million tonnes per annum (MTPA), implying a CAGR of 7.8% since FY 07. The Cargo traffic during FY 17 for the three categories of solid, liquid and container cargo was 310.8, 212.4 and 124.6 MMT,

respectively which indicates a CAGR of 3.4% between FY07–17. Similarly, during FY07–17 the container traffic rose to 124.6 MMT, implying a CAGR of 5.9%.

1.4 Another feature of Indian Shipping is that the coastal trade of India is exclusively reserved for Indian ships and for this purpose a ship chartered by a citizen of India or a company which satisfied the requirements laid down in Section 21 of the Merchant Shipping Act, 1958 is deemed to be an Indian ship. A foreign ship is normally not allowed to ply in the coastal trade of India except under certain conditions and that too after a license is granted to it by an officer authorized to issue it. This is the reason why a few foreign ship owners are now seeking to register one or two of their ships under the Indian flag to carry cargo on local routes.

1.5 A crucial aspect to be kept in mind is that the shipping sector in India is largely served by International Shipping lines, which have considerable turnover and significant presence in the Indian Shipping business. These lines fly a foreign flag. The market share of Indian Shippers is less than 10% of the total cargo movement while the foreign vessels carry over 90% of Indian cargo. According to the latest data from Indian National Shipowners' Association, in FY15–16, the share of Indian ships in the carriage of EXIM cargo was a miniscule 7.86%. Though, there are a few large Indian players, but according to some estimates, around 35% of the total fleet owned and controlled by Indian interests is also flagged overseas.

2. MAJOR INDIAN PLAYERS

The major Indian players in the shipping industry are the following:

a. Shipping Corporation of India Ltd.

b. Great Eastern Shipping Companies Ltd.

c. Essar Shipping Ltd.

d. Mercator Ltd.

e. Seaways Shipping & Logistics Ltd.

f. Tolani Shipping Pvt Ltd.

3. BUSINESS OPERATION & PROCESSES

3.1 Operation & Processes: The Shipping Industry plays a pivotal role in the export and import of goods. The Shipping line companies provide vessels/ ships for export/ import of goods by the exporter/ supplier or importer/ customer. The 'Shipper' is the person whose goods are transported or who places a shipment order with the shipping line. It is mentioned that recently the Customs Department has revised the designation of 'Customs House Agents' (CHA) to that of 'Customs Broker' in line with international terminology. The business operation process of shipment of exports and imports are tabulated below for easy comprehension.

3.2 Export Processes:

Process	Process Owner
Booking is placed with the Shipping line by the Exporter or Forwarder or CHA (Customs House Agent)	Exporter/ Customs Broker (CHA)
Shipping line accepts the booking and release bookings for container pickup from empty yard (called Delivery Order)	Shipping Line
Exporter picks up containers from empty yard	Exporter/ Customs Broker (CHA)
Shipping Bill and Invoice raised on customers prepared simultaneously for declaration to customs.	Exporter/ Customs Broker (CHA)
Shipper does stuffing activity in the containers either at the CFS (Container Freight Station) or at their factory premises.	Exporter/ Customs Broker (CHA)
Weighment done and Verified Gross Mass (VGM) work is done.	Exporter/ Customs Broker (CHA)

Let Export Order (LEO) issued by Custom at the exit from CFS or designated area for factory stuffed container.	Exporter/ Customs Broker (CHA)
Shipper applies for Form 13 request to shipping line	Exporter/ Customs Broker (CHA)
Copy of booking, checklist of shipping bills/ CLP (Classification, Labelling and Packaging), VGM is given to shipping line by CHA/ Exporter	Exporter/ Customs Broker (CHA)
Shipping Instructions (SI) is placed with shipping line by shipper either through online or off-line/ physical modes.	Exporter/ Customs Broker (CHA)
Form 13 is issued to the Exporter's representative by the shipping line giving details of the POD (Port of discharge), cut off time for loading.	Shipping Line
Draft Bill of Lading (BL) prepared by CHA/ Shipper and is sent to Shipping Line. A typical draft BL contains the cargo details like type, dimension, weight, charges (as agreed), consignee and consignor name, POO (Port of Origin), POL (Port of Lading), Port of Discharge etc. It also includes the LC details if there is one involved.	Exporter/ Customs Broker (CHA)
The shipping line checks the draft BL and prepares its BL and sent to Shipper for final check. After that a final BL is issued by the Shipping Line giving all payment terms also.	Shipping Line
On-board of containers is conveyed to the shipper	Shipping Line

3.3 Import Processes:

Process	**Process Owner**
Order placed on foreign supplier. Terms of delivery, details of payment etc are all finalised. The Incoterms are decided i.e. whether CIF or FOB etc.	Importer
Supplier's BL, certificate of origin, packing list, invoice and other certificates sent to importer by courier.	Foreign Supplier
On basis of documents the Importer/ Customs Broker files advance Bill of Entry online (72 hours prior).	Importer/ Customs Broker (CHA)
Assessment by Customs Appraiser/ Customs officer. Duty payable ordered.	Customs
After payment of duty, examination of cargo is done and Out of Charge is given.	Customs
The importer pays CFS charges and carries out the goods. In Maharashtra a stamp duty 0.1% on assessable value of customs and customs duty combined.	Importer/ Customs Broker (CHA)
The Shipping Line also takes a guarantee on stamp paper of Rs. 500/- as to the safe return of the container.	Shipping Line
The CFS verifies the payments online and allows delivery of the container.	CFS
The Importer/ Customs Broker (CHA) arrange to return the Empty container to the designated Empty Yard where the container is surveyed and offloaded if found in sound condition. If it is damaged, the costs have to be paid.	Importer/ Customs Broker (CHA)

After Feb 2016 some Ports have started a Direct Port Delivery (DPD) scheme for full container load case. The other 'less than container loads' (LCL) are still being sent to CFS only.

4. PROFIT MARGINS AND RATIO ANALYSIS

The profit margin in this industry depends upon the various factors of market and economy, like any other industry. While the Shipping Industry can get itself assessed as an ordinary business entity, the Indian shipping industry is dominated by tonnage tax and gross basis of taxation. The International shipping companies of non-residents on the other hand are governed by Section 172 of the Act in general or by Section 44B of the Act if they have a permanent establishment. These provisions also offer a gross basis of taxation for such companies.

5. SPECIAL PROVISIONS FOR CERTAIN INDIAN SHIPPING COMPANIES

5.1 Tonnage Scheme: As already mentioned earlier, the bulk of the shipping industry in India operates under foreign flags. The heavy investment, maintenance costs and the international competition are features hampering the growth of the Indian shipping industry. To support the industry, incentives were provided under the Income-tax Act, 1961 (hereinafter the Act) under Section 33AC till Assessment Year 2005–06. After AY 2005–06 a new Chapter XII-G was inserted in the Act, whereby a presumptive method of tax computation for Indian Shipping Industry was introduced based on the tonnage income. These provisions were introduced to make the taxation process simpler, providing certainty in taxation and to promote further investment in this sector so as to avoid de-flagging of Indian ships (switching ships' registration to a foreign jurisdiction). The tonnage tax is a common feature worldwide and a conscious decision has been taken by the Government to keep the taxation at a low rate in order to ensure that the Indian shipping remains internationally competitive. The tonnage scheme is optional and the shipping company can either pay that tonnage tax or the normal corporate tax on its profits.

5.2 To be eligible for the tonnage tax, the shipping company has to be an Indian company, having the place of effective management in India. It should also own at least one qualifying ship and the main object of the shipping company should be to carry on the business of operating ships. The term 'Qualifying Ship' has been defined in Section 115VD of the Act to mean a sea going ship or vessel of fifteen net tonnage or more and it should be registered under the Merchant Shipping Act, 1958 or should be functioning under a license issued by the Director-General of Shipping under Section 406 or 407 of the Merchant Shipping Act, 1958. It is also mandatory that in order to claim the tonnage tax the ship should have a valid certificate in force indicating its net tonnage. The provisions of tonnage tax do not apply to a seagoing ship or vessel if the main purpose for which it is used is the provision of goods or services of a kind normally provided on land. It is also not applicable to fishing vessels, factory ships, pleasure crafts, Harbour & river ferries, offshore installations and even a qualifying ship which is used as a fishing vessel for a period of more than thirty days during a previous year.

5.3 The tonnage tax scheme is a presumptive scheme of taxation where the income arising from the operation of a qualifying ship is determined on the basis of its tonnage. Since, it is a preferential regime of taxation, conditions like the assessee has to transfer 20% of the book profit to a Tonnage Tax Reserve Account to be Utilised as per Section 115VT of the Act are required to be met.

5.4 For the purpose of computing the income under tonnage tax scheme, the shipping business is to be considered as a separate business distinct

from all other activities or business carried out by the company. The assessee has to maintain separate books of account and has to comply with the requirement of furnishing necessary audit report in the prescribed Form No. 66. The assessee has to make a specific claim that it seeks to opt for the tonnage tax scheme. The assessee has to make an application in this regard which needs to be approved in writing as per the provisions of Section 115VP of the Act. There are provisions for continuation/ discontinuation/ renewal/ prohibition from claiming of benefit of the tonnage tax scheme. There are also limits prescribed in terms of maximum percentage of chartered in net tonnage.

5.5 The tonnage tax scheme shall not apply where a tonnage tax company is a party to any transaction or arrangement which amounts to an abuse of the tonnage tax scheme. The tonnage income is taxed as per the normal corporate rate applicable and the taxes are payable even if there is a loss. The CBDT Circular No. 5 of 2005 dated 15.07.2005 and Circular No. 3 of 2006 dated 27.02.2016 contains the explanatory notes regarding the Tonnage Tax Scheme.

5.6 The income of a tonnage tax company for a previous year is computed on the basis of its deemed daily tonnage income which is then multiplied by the number of days in the previous year or the number of days where the ship is operated as a qualifying ship for a part of the previous year. Presently, the computation of tonnage income is done as mentioned in the table below:

Qualifying ship having net tonnage	Amount of daily tonnage income
(1)	(2)
up to 1,000	Rs. 70 for each 100 tons
Exceeding 1,000 but not more than10,000	Rs. 700 plus Rs. 53 for each 100 tons exceeding 1,000 tons
Exceeding 10,000 but not more than 25,000	Rs. 5,470 plus Rs. 42 for each 100 tons exceeding 10,000 tons
Exceeding 25,000	Rs. 11,770 plus Rs. 29 for each 100 tons exceeding 25,000 tons.

5.7 As per Section 115VI of the Act, the relevant Shipping income of the tonnage tax company means its profits from core activities referred to in Sub-section (2) and the incidental activities which are incidental to the core activities and are prescribed in Rule 11R of the Income-tax Rules 1962. The incidental activities are maritime consultancy charges, income from loading or unloading of cargo, ship management fee or remuneration received for managed vessels and maritime education recruitment fees. In the case of *Dredging Corporation of India Ltd vs. ACIT* (2017) 167 ITD 485 (Vishakhapatnam), the Hon'ble ITAT has held that the receipt of interest from house building advances, liquidated damages and the interest on the principal amount of the arbitration award are not profit from core activities or incidental activities and hence are required to be taxed separately.

5.8 Similarly, in the case of *Shipping Corporation of India Ltd vs. Addl. CIT* (2014) 31 ITR(T) 545 (Mumbai-Trib) it has been held that the profit on sale of ships and fixed ships is to be deduced from the turnover of core activity of Shipping. Further, in this case, the assessee had declared income from interest and dividend as income from other sources but had allocated administrative expenses against these incomes claiming that the same is required to be treated as core shipping income and common administrative expenses are to be allocated amongst the different business activities of the assessee on a reasonable basis in terms of the provisions of Section 115VJ of the Act. This

explanation of the assessee was not found acceptable by the Assessing Officer who noted that the apportionment of common cost as envisaged in Section 115VJ(1) of the Act was amongst other "business" or "activity" carried on by the tonnage tax company and such activity ought to be a business relate activity. The AO held that the income earned by the assessee on account of interest on monies deployed out of surplus funds as well as dividend income was chargeable to tax under the head "Income from other sources" and the assessee therefore was not entitled to claim the deduction on account of apportionment of common costs as provided in Section 115VJ of the Act. He held that the assessee was entitled to deduction against such income only on account of expenditure wholly and exclusively incurred for the purpose of earning such income to that extent available under Section 57(iii) of the Act.

5.9 The Act mandates that for the purposes of the tonnage tax scheme, the tonnage of a ship is indicated in the relevant certificate and includes the deemed tonnage computed, as per Rule 11Q of the Income-tax Rules, 1962. These rules give the computation of deemed tonnage in respect of an arrangement of purchase of slots and slot charter and an arrangement of sharing of break-bulk vessel based on the container size, cargo volume and cargo weight. The relevant Form No. 66 gives detailed working notes for computing the deemed tonnage and incidental activities. This Form should be carefully analysed by the Assessing Officer.

5.10 The tonnage scheme also provides for computing the chargeable capital gains on transfer of tonnage tax assets, treating the written down value of the block of qualifying assets, as a separate block as per Section 115VN of the Act.

5.11 For the purposes of MAT, the book profit or loss derived from the activities of a tonnage tax company is excluded from the book profit of the company for the purposes of Section 115JB but the capital gains arising from the transfer of tonnage tax assets are retained since it is not covered under the scope of 'profits from core activities', as mentioned in Section 115VI of the Act.

6. POINTS FOR INVESTIGATION IN TONNAGE TAX SCHEME

The two main points for investigation under the Tonnage Tax Scheme are elucidated as under:

a. The assessee may include the income not covered under the Tonnage Tax Scheme in the Tonnage Tax qualifying income so as to reduce their tax incidence. In some reported cases, it has been found that income under the head 'Other Sources' like interest was also included in the Tonnage Tax qualifying income.

b. Simultaneously, the expenses incurred in Tonnage Tax business are diverted to non-qualifying business so as to reduce the non-qualifying income. In some cases, the major portion of common cost is allocated to non-qualifying activity. As regards the expenses, Section 115VJ of the I.T. Act provides for allocation of such expenses on a reasonable basis by the Assessing Officer. In majority of the cases, such expenses are sought to be allocated on the basis of turnover which need to be rationally allotted after due verification.

7. TAXATION OF FREIGHT INCOME OF INTERNATIONAL SHIPPING COMPANIES

7.1 The provisions for taxation of freight earned by a non-resident shipping company from its operations in India are contained in Section 44B and Section 172 of the Act.

7.2 Section 44B: If a non-resident has a permanent establishment in India and is engaged in the business of operation of ships, it can choose to be taxed as per the provisions

of Section 44B of the Act which provide that the income of the non-resident from its ship activities would be calculated @ 7.5% of the sums: whether paid or payable, in India or out of India, to the assessee or to any person on his behalf on account of carriage of passengers, livestock, mail or goods shipped at any port in India; carriage of passengers, livestock, mail or goods shipped at any port outside India, and Demurrage charges or handling charges and other similar charges. The issue of existence of permanent establishment/ business connection would then be examined at length as there is a tendency on the part of the non-resident to mis-represent the facts.

7.3 Section 172: If the non-resident is engaged in occasional shipping business (through owned or chartered ships) in international traffic, its taxation is governed by Section 172 of the Act, which is an overriding provision with respect to occasional shipping business of a non-resident. Where such a ship carries passengers, livestock, mail or goods shipped at a port in India, 7.5% of the amount paid or payable on account of such carriage to the owner or the charterer or to any person on his behalf is deemed to be the income accruing in India to the owner or charterer on account of such carriage irrespective of the fact whether the amount is paid or payable in or out of India. The income shall also be deemed on the amount paid or payable by way of demurrage charges or handling charges or any other amount of similar nature. The tax thereon is levied as per the rate or rates in force as referred to in Section 194 of the Act.

7.4 Before departure from any port in India of any such ship, the Master of the ship shall prepare and furnish a return of the full amount paid or payable to the owner or charter or any person on his behalf. The Master of the vessels or their authorized agent should file provisional return along with original copy of Master Certificate issued by the Master of vessel before departure of vessels. If the return cannot be filed before departure of the vessel, the Master is required to make necessary arrangements for filing of return and payment of taxes within 30 days of departure of the vessel. A Port clearance *u/s* 172(6) shall be granted to ship only after such satisfactory arrangement or the payment of tax.

7.5 If the principal beneficiary has availed the benefit of freight tax paid *u/s* 172(2) of the Act, he may file regular return *u/s* 44B of the Act before the expiry of the assessment year concerned. For this purpose, any tax paid during the previous year *u/s* 172(2) shall be treated as a payment in advance of the tax.

7.6 On receipt of the return, the AO is required to assess the income before the expiry of nine months from the end of the Financial Year in which the return under Section 172(3) of the Act is filed. In order to finalize the assessment *u/s* 172(4), the AO may call for such accounts or documents as he may require i.e. bank accounts details remittance of freight. The levy of and the recovery of tax has to be from the Master of the ship.

7.7 Where the owner or charterer of the ship claims the benefit of Double Taxation Avoidance Agreements the assessing officer should carefully examine the claim of treaty benefit claimed. Misrepresentation of facts with respect to claim of treaty benefit has been noted in a number of cases–especially with reference to UAE and Singapore Treaty. It should be ensured that the double taxation relief is granted subject to verification of tax paid/ payable outside country, wherever India had entered into any DTAA. The onus is on the assessee to produce the requisite documents to evidence tax residency and eligibility to treaty benefit. A careful examination of the Limitation of Benefit Clauses in the treaty is a must.

7.8 Some of the documents which require verification during assessment are, as under:

a. Original copies of Master Certificate.

b. Incorporation certificate of principal beneficiary.

c. Tax residency issued by the competent authorities of outside countries. i.e. TRC is issued on a year to year basis (i.e. every calendar year).

d. Vessel registration certificate, if the vessel is owned by the principal.

e. The Ship Manifest which indicates the amount of freight collected; the expenses including Agency Commission and Income-tax paid/ payable for the voyage; and net surplus to the credit of the owner or deficit for the voyage.

7.9 The income of the Non-resident Shipping company can be verified by ensuring that the following three amounts are the same:

a. The sum total of all the Bills of Lading issued by the Indian Agent for a single voyage;

b. The amounts of freight collected for the voyage and deposited in the Collection Account of the Non-Resident Shipping company; and

c. The amounts shown to the credit of the voyage account as freight collected and credited through a bank account in the books of Indian Agent.

7.10 Although Section 172 represents a complete code in itself, reassessment proceedings *u/s* 147 have been upheld in such cases by Delhi High Court in the case of Emirates Shipping Line, FZE, [2012] 23 taxmann.com 400 (Delhi)

8. INTERPLAY OF DTAA AND POINTS OF INVESTIGATION

8.1 In most of the DTAAs, the shipping income is taxed on the basis of residence. Shipping business can be carried out by an enterprise who can be the owner of the vessel, a charterer of the vessel or a lessee of the vessel. Hence, while examining a case of a charterer or a lessee, it is important to find out whether the charter agreement has been entered into only to claim treaty benefit. There have been claims of India UAE DTAA by various parties who belonged to a non-treaty country claiming that the ship was chartered by a UAE based associate. It is easy to draw a charter party agreement between associates. Hence, the claim of treaty benefit should be examined closely as UAE Treaty benefit is available only to a company wholly managed and controlled in UAE and Article 29 prohibits Treaty abuse. In the international shipping business, chartering (hiring) of a ship is very common. Many times, the actual person who is transporting goods in a ship may be the second or the third charterer and not the original owner of the ship. Many times, merely to take benefit of a treaty, a charterer having place of management in a favourable country may claim to be the actual charterer although the freight may have been paid to someone else. It is important for the Assessing Officer to determine the actual freight beneficiary and then determine whether the freight beneficiary has effective management in the country whose DTAA benefit is being sought by the ship operator.

8.2 In the case of *Marine Links Shipping Agencies* [2013] 40 taxmann.com 88 (Karnataka), it was noted that as per charter agreement the charterer merely retained 3.5% of the consideration and passed on the remaining amount to the ship owner. Under the circumstances the Karnataka High Court denied the benefit to the charterer observing that the appellant was acting as an agent of the owner and not operating as a charterer.

8.3 In the case of *DLJMB Mauritius Investment Co.*, [1997] 94 Taxmann 218 (AAR), it was held by AAR that the term 'place of effective management' would mean a place from where, factually and effectively, the day-to-day affairs of the companies are carried on and not the place in which may reside the ultimate control of the company. Similar view was held by ITAT in the case of *Integrated Container Feeder Service* [2005] 96 ITD 371 (Mum).

8.4 In case of ships owned/ chartered by Singapore based entities, there have been frequent violation of Article 24 which limits treaty benefit to amount of income received in Singapore. It has been noted that since Singapore does not tax income which does not arise in Singapore, the freight collected in India is remitted to a branch in UK or any other country while the benefit of India Singapore DTAA is claimed while filing the return. In the case of Thoresen Chartering Singapore (Pte.) Ltd., [2008] 24 SOT 433 (MUM.), the ITAT held that the amount of income which was not remitted to or received in Singapore was not entitled to the benefit of article 8 as it was hit by Article 24.

9. BENCHMARKING OF VESSEL HIRE CHARGES PAID BY INDIAN COMPANY TO ITS AE

9.1 In one case, the Indian Company has taken various ships on hire from its Associated Enterprise (AE) on Voyage Charter basis. In Voyage Charter, the rates are charged on per tonne basis from one port to destination port. It is different from a Time Charter. In Voyage Charter, the entire expense belongs to the Ship Owner whereas in Time Charter the fuel and the port charges are to be borne by the Charterer. In this particular case, the AE itself did not own the ships also and had taken these ships on hire from third parties. However, the AE had taken the ships on hire on Time Charter basis but had given them on hire to the Indian Company on Voyage basis and had charged Freight and Demurrage charges as is usually done under Voyage Charter.

9.2 Under these circumstances, the Indian Company was asked to benchmark the Vessel Hire charges paid to the AE using the Clarkson Database. The Clarkson Research Services Limited publishes *Shipping Intelligence Weekly Report* containing the time charter rates of vessels. It was to be noted that in the Clarkson's database, the rates are of Time Charter rates and the Voyage charter rates in the area of operation of the assessee were not available. However, by excluding the fuel and port charges, the Voyage charter rate were converted to Time Charter rates and such derived Time Charter rates could be compared with Time Charter rates as per the Clarkson Database. On an analysis, it was found that out of 20 such transactions, the derived time charter rates paid to the AE in 4 transactions was higher than the Clarkson's rate. Accordingly, an adjustment was made on account of vessel hire charges paid to AE.

10. COASTAL SHIPPING BY NON-RESIDENT COMPANIES

Coastal shipping cannot be considered as international shipping and hence a non-resident offering costal shipping services is liable to tax in India. However, coastal shipping which forms a part of the international shipping operations of an enterprise has been held to be in the nature of International shipping–Essar Oil Limited [2006] 5 SOT 669 (Mum) However, while dealing with the issue of coastal shipping in the case of Poompuhar Shipping Corpn. Ltd. [2013] 38 taxmann.com 150 (Madras), the Madras High Court held that the amount paid to the ship owner with respect to the ship chartered by the Indian party for operating in coastal shipping was to be held as royalty and taxed as such in India. The Court also held that when the Shipping Corporation enters into Time Charter agreements with foreign shipping companies and exclusive berthing facility at ports are guaranteed for ships of such companies, this amounts to Permanent Establishment and there is no need of having a separate Permanent Establishment.

11. OTHER ISSUES IN INTERNATIONAL SHIPPING CASES

11.1 Internal Haulage Charge: The IHC are charges which the Enterprises, which operate ships in international traffic, collect from the Indian clients for undertaking transport of containers inland by arranging such transportation on their

own or through third party service providers. Internal haulage charges, if incurred by the same person engaged in International Shipping, has been held to be connected to and a part of the income from International Shipping. However, it is important to examine whether the same party is carrying out the internal haulage work. Internal haulage carried out by a third party cannot constitute a portion of the international shipping activity of a non-resident.

11.2 It is also to be noted that the Explanation below Section 44B of the Act which specifically mentions as under:

"Explanation.-For the purposes of this sub-section, the amount referred to in Clause (i) or Clause (ii) shall include the amount paid or payable or received or deemed to be received, as the case may be, by way of demurrage charges or handling charges or any other amount of similar nature".

The above Explanation, *noscitur a sociis*, suggests that only the charges which are directly linked to the business of operation of ships can be considered u/s 44B of the Act. The IHC are charges collected for picking up and dropping the goods to and fro the port to the warehouse of the exporter/ importer. This could be by road or rail or any other means but this income is certainly not shipping income and cannot be taxed under Section 44B.

11.3 Slot Chartering: Most of the Treaties entered into by India include income from operation of ships, participation in a pooling arrangement and operation of a joint shipping business under the definition of shipping income covered by the DTAAs. Hence, a travel agent solely engaged in slot chartering would not be covered by the Treaty benefits as held by Bombay ITAT in the case of *Delta Airlines Inc* [2015] 57 taxmann.com 1 (Mumbai-Trib.). This was the case of an airline but the underlying principle is the same.

11.4 Many assessees engaged in international shipping terminate their journeys at mother ports *viz.* Colombo and thereafter transport the goods to Indian ports by means of 'feeder vessels' which were neither owned or chartered by the assessee. The Department has regularly held that the freight earned on account of such feeder vessels activities are not covered by the DTAA concerned and the Department seeks to distinguish that the feeder vessels are not covered by the term 'pool or slot arrangement'.

11.5 Rig Haulage Charges etc.: If a rig is hired by an Indian company for operation in India, the income arising from mobilisation and demobilisation of drilling vessel outside India is taxable as fees from technical services under Section 9(1)(vii) of the Act. The issue has been set to rest by Uttarakhand High Court in many cases including the case of *CIT vs. Atwood Oceanics Pacific Ltd.*, dated May 19, 2010, [2011] 338 ITR 156 (Uttarakhand).

12. CBDT CIRCULARS

12.1 Circular No. 30/ 2016 [F.No.500/05/2014-FTD-I], Dated 26-8-2016:

This Circular was issued by CBDT in continuation of its earlier Circular No. 732 dated 20/12/1995. The earlier Circular had done away with the procedure of obtaining NOC for each voyage in cases covered by full DTAA. As per the Circular No 732, the AO is competent to issue annual NOC valid for a year after carefully verifying the applicability of DTAA. It was reiterated that the annual NOC should clearly mention the names of the ships owned by the foreign shipping company, names of the ships chartered or names of shipping companies from which ships are chartered by the foreign shipping company and names of the members of the pool and their ships which are part of this pool. The AO was also directed to continue to take the declaration from the applicant that the treaty benefits

would be available only in respect of freight in international traffic. The Circular also laid down the manner in which the Issuance of Voyage NOC is to be dealt.

12.2 The Circular also simplified the Voyage Assessment process. It was directed that in cases where a foreign shipping company eligible for full treaty relief prefers to be assessed on a voyage-wise basis *i.e.*, on a ship basis, the Port Assessing Officer before whom such a voyage return has been filed shall give due credit to the annual NOC issued by the AO. Assessment in such cases must be expeditiously done and without conducting any further verification with respect to the eligibility of the foreign shipping company as regard to treaty benefits and the annual NOC issued by the jurisdictional AO must be honoured. In other cases, *i.e.*, in a situation where the foreign shipping company files an intimation under Section 172(7) expressing its willingness to be assessed on an annual basis instead of on a voyage basis, the voyage assessment before the port Assessing Officer should cease and the port Assessing officer shall intimate the details of voyage and freight in respect of that foreign shipping company to the Assessing Officer issuing the annual NOC.

12.3 Circular No. 9/ 2001 dated 09/07/ 2001: In the Circular No 9/ 2001, the CBDT has directed that in case of a regular assessment under Section 172(7), the non-resident assessee is liable to pay interest under sections 234B and 234C and is also entitled to receive interest under Section 244A of the Income-tax Act, 1961 as the case may be.

12.4 Circular No 732 dated 20.12.1995: This Circular had provided for issuance of an annual NOC, in respect of taxation of Shipping Profits under Section 172. Under this Section seven and a half per cent of the amount paid or payable to the owner or charterer of a ship on account of carriage of passengers, livestock, mail or goods shipped at a port in India, is deemed to be income accruing in India to the owner or the charterer and the port clearance is granted only after the return of the full amount to be paid is filed, evidence of payment of tax on such income is produced before the Customs authorities, or satisfactory arrangements are made to file the return and pay the tax within thirty days of departure of the ship. In cases where such ships are owned by an enterprise belonging to a country with which India has entered into an agreement on avoidance of double taxation, which provides for taxation of shipping profits only in the country of which the enterprise is a resident, no tax is payable by such ships at the Indian ports. Under such circumstances, a 'No Objection Certificate' only is to be obtained by the master of the ship from the concerned Income-tax authority. Vide the Circular No 732 the CBDT had directed that where such a DTAA is applicable the Assessing Officer shall be competent to issue an annual NOC, valid for a year, in respect of taxation of shipping profits under Section 172 of the Income-tax Act, 1961 after carefully verifying the applicability of the relevant provisions concerning taxation of shipping profits in the DTAA with the country of which the owner or the charterer is a resident. It was also directed that the AO should ensure that the non-resident shipping company is engaged in 'international traffic', a term which is invariably defined in the DTAA itself. An undertaking from the non-resident company that during the period of the currency of the NOC, no ship belonging to it will be in any traffic other than 'international traffic', shall be obtained before the issue of the NOC. This Circular has been further elaborated by Circular No 30/ 2016.

12.5 Circular No 723 dated 19/ 09/ 1995: This Circular is in relation to Tax Deduction at Source from payment made to foreign shipping companies under 194C and 195. This Circular had provided that Section 172 is a self-contained code for the levy and recovery of the tax and the provisions of Section 172 are to apply and those of sections 194C and 195 will not apply.

13. SOURCES OF INFORMATION

13.1 Website and Statutes: The website www.dgshipping.com is the official website of Directorate General of Shipping, Government of India and contains details of Shipping Act, Shipping manual and other Shipping Laws which may be considered for clarifications relating to ships registered in India.

13.2 The Registration of Ship in India is made with the Registrar of Indian ships, who issues he necessary certificate under Merchant Shipping Act, 1958. The Registrar of Indian Ships also issues Tonnage Certificate under the provisions of the 'International Convention of Tonnage Measurement of Ships (1969). This certificate contains details of Gross Tonnage and Net Tonnage along with dimensions of the ship.

14. ADDITIONAL POINTS FOR INQUIRY/ INVESTIGATION

14.1 Shipping Agents: In the cases of Shipping agents, the two areas where evasion has been detected by Officers are:

a. Receipt of cash commission from contractors.

b. Receipt of excess freight from Shippers without the knowledge of the Principals while in the Balance Sheet, the difference may be shown as amount payable to the Principals.

14.2 Receipt of Cash Commission: To understand this aspect, the practices followed by the Shipping agents and the contractors hired by them have to be understood. The cargo handled by Shipping agents is either Container cargo or Break Bulk cargo. Broadly the modus operandi remains the same but there are some critical differences in the two kinds of cargos handled. As far as container cargo is concerned the Shipping agents receive the goods to be exported at pre-designated points called the Container Freight Stations (CFS) or at Inland Container Depots (ICDs). After examination by the Customs authorities, these goods have to be stuffed into empty containers. The containers are then carried inside the port area upto the hook point of the ship, from where these are loaded on to the ship. Similarly, an import container has to be unloaded from the ship and carried to the CFSs/ ICDs where the container is destuffed for examination by the Customs authorities. The empty containers are removed from the port to the container storage yards. The Shipping agents hire transporters for carrying the containers inside the port area, and for movement to and from the container storage yards, for stacking of the containers in the storage yards and for return of containers to the yard. These transporters are also referred to as container handlers. They are specialised transporters owning machines such as Forklifts, Trailers, Reach Stackers, Top lifters, etc.. There are other specialised service providers for stuffing and destuffing of containers called Stevedores. Moreover while the ship is at the port, there are certain expenses to be met, such as repairs, provisions etc.. The Shipping agents engage various contractors (Transporters, Stevedores) and make payments to them from the freight collected on behalf of the Principals and remit the balance to the Principals. During searches conducted in the cases of some Shipping agents and contractors at Mumbai, documentary evidence was unearthed indicating that these Shipping agents were receiving 8% to 12% of the gross bill amount, as cash commission from transporters and Stevedores in return for the business given to them.

14.3 In the case of non-containerised/ Break bulk cargo the Shipping agents hire forklifts and trucks for movement of cargo inside the port. In the case of container ships, the main vessels or mother ships very rarely visit Indian ports and feeder vessels carrying 1000 to 2000 containers visit Indian ports and carry the containers to

and from trans-shipment or hub ports such as Colombo and Dubai. The turnaround time for such feeder vessels is around 48 hours or less, and hence certain services such as Chandelling (providing supplies to the ship) and fresh water etc. are not required. On the other hand in case of break bulk cargo, the main vessels arrive at Indian ports and their turnaround time is often more than a week. Hence, various other services are to be provided by the Shipping agents through contractors on which they receive commission. Shipping agents are known to introduce bills in the names of bogus parties. These parties may appear as sundry creditors in the books of the agents.

14.4 Balances Wrongly Shown as Payable to the Principals: Another important area of concealment pertains to balances lying in the books of shipping agents as due to the Principals. This difference in balance as appearing in the accounts submitted to the Principals, and as reflected in the Balance Sheet of the agents, arises out of certain practices followed by agents. The agents collect freight on behalf of the Principals from the Shippers. The Principals have fixed fares from different destinations. Sometimes, the agent acting through the Clearing & Forwarding agents manage to get higher freight rates from the Shippers. For example, the Principals may have fixed a rate of USD 200 per 20 ft container for Mumbai to Singapore but the agent may quote and get a rate of USD 300 from the shipper. The agents normally follow two distinct practices to account for the difference. On the one hand the agent may reflect the entire amount of freight received (i.e. USD 300) as gross freight in the voyage account and claim a deduction of USD 100 as freight rebate payable/ paid. This amount of USD 100 is then credited to an account called Freight Rebate Payable Account, in the books of the agent. Thus, the balances lie as freight rebate payable. Only the net freight of USD 200 is repatriable to the Principals. This pre-supposes that the Principals are aware of and agree to the fact that the agent has charged extra amount since the voyage account is sent to the Principals. On the other hand, the agent may reflect only USD 200 in the voyage account while actually receiving USD 300. In this case the excess freight collected is reflected as part of the balance payable to the Principal in the Balance Sheet of the agents, whereas, in the statements sent to the Principals the balances would be a lower figure since only the net freight is shown to him. Needless to say, the Principals are not aware of the difference.

14.5 Most Shipping agents follow the first system of accounting, i.e., the entire gross freight is credited to the voyage account and brokerage @ 2% is debited from the same and credited to the brokerage payable account. The excess freight collected is debited and credited to a Freight Rebate payable account. The accounting in respect of brokerage payable account is that 2% of the gross freight is debited from every voyage accountand credited in the name of the Principals to an account called the brokerage payable account. Payments of brokerage are made out of the brokerage payable account. Part of the brokerage provided for and credited to the brokerage payable account is paid after a substantial period of time while part of the brokerage provided is never paid. Hence there are substantial balances in these accounts at all times.

14.6 Similar to these, are the Freight Rebate payable accounts. The Shipping agents give rebates out of the gross freight. These may be because the agent is receiving more freight than fixed by his Principals. The gross freight is credited to the voyage account and all rebates payable are debited to the voyage account and credited to the freight rebate payable account of the Principals. The balances arise because some of the freight rebate provided for is never paid.

14.7 Similarly, balances also remain in the Inland Haulage Payable accounts. IHC pertain to transportation charges of containers from ICD to the port of shipment. The Principals through his agent charge the Shipper for the same. The payment is made by the agent for the same to the transporters handling the inland transportation, which in most cases is CONCOR, the subsidiary of Indian Railways, which is engaged in container movement. The accounting practice followed by the agents is that the IHC received/ receivable is credited to the voyage account of the ship. The IHC payable is debited to the voyage account, and then credited to a separate account called Inland Haulage Payable Account. Subsequently, haulage is paid by debiting Inland Haulage Payable Account. Sometimes for the same container IHC is recovered from the Principal as well as the Shipper (importers/ exporters). This happens because, at times, the Principal receives freight from the foreign party upto the ICD point while the agent also collects the IHC from the Shipper and debits the Principal's Voyage Account for the same. The balance in the Inland Haulage Payable Account, represents the excess inland haulage, collected by the Shipping agents. Such balances remain lying in the books of accounts for years and run into crores of rupees.

14.8 The main points for investigation would be whether the payments have been actually made to genuine parties and if yes, for what services rendered? And whether such balances represent actual liabilities towards Principals or other service providers or require to be treated as income of the agent. Investigations have in some cases revealed that while the bills for brokerage mentioned the term brokerage, the bills for freight rebate, and marketing service charges etc. were actually issued for shifting and transportation. The payments of these charges were being shown after a considerable length of time and no record was kept as to who received these payments. No register or record indicating the name of the freight broker or the person entitled to claim rebate was being maintained. Neither the bill of lading, nor the shipping bill, or the bill of entry carried the name of the broker or Clearing and Forwarding agent. The only name appearing on these documents was of the Custom house agent.

14.9 The Shipping agents are not in direct contact with the Shippers. It is the Clearing and Forwarding agents and freight brokers who do the marketing functions. They approach the prospective importers/ exporters and canvass for their business. They offer rates to them and after bagging the business, they approach different agents whose ships are plying on the desired route. They negotiate freight rates with the Shipping agents. Often, they are able to get better rates from the Shippers than the ones quoted by the Shipping agents. This difference in rates is called freight rebate. If the Shipper makes the payment directly to the Shipping agents, then the amount of rebate is to be passed on by the Shipping agents. On the other hand, if the payment is made through the Clearing & Forwarding agents, then the shipping agents receives only the net freight and no question of paying any freight rebates arises. Moreover, brokerage of 2% is the industry norm. Besides bringing business the CFAs and freight brokers also track the movement of the containers inside the port. They are also responsible for timely collection of freight and port dues from the Shipper. For these services, they receive the brokerages and rebates.

15. CLEARING & FORWARDING AGENTS—A CASE STUDY

15.1 A leading Clearing and Forwarding agent of Gandhidham, engaged in stevedoring, clearing, forwarding, handling and transportation at Kandla port, was searched *u/s* 132. During

these searches, it was found that the difference between "funds receivable" and the 'bill amount', was collected in cash from the Shipper. On an overall analysis of the seized papers, it was admitted by the main partner/ director, that an amount of Rs. 3.22 crore was received in cash outside the books of account, from various importers/ exporters, during FY 1994–95 & 1995–96. Two things became clear, namely, (i) Large unaccounted funds were generated by reporting inflated figures of expenditure to the Shippers, and (ii) Nearly 40% of the amount was received from the Shippers in cash.

15.2 Besides, from the office premises, a set of s, cheque books, pass books, blank vouchers of 21 bogus labour contractors were found, indicating that labour bills for the work purportedly got done through these labour/ transportation contractors, were inflated, and such inflated amounts paid to them through cheques, were routed back to the assessee by using their blank signed cheque books lying in the custody of the assessee. Some of these persons were found to be employees of the group; others were drivers of the trucks owned by the group. After detailed inquiries, it was established that payment of Rs. 2.31 crores made to these 21 parties was received back in cash by the group after withdrawing the same from the respective bank accounts. It transpired that since many of the Shippers were PSUs who were not in a position to make cash payments, inflated bills were raised in their cases by showing bogus/ inflated expenses on their behalf in the names of bogus/ benami concerns and withdrawing such amounts from the books through benami bank accounts. Thus, on the one hand, unaccounted cash was being received from Shippers, and on the other hand, bogus expenses were being debited through benami labour contractors.

15.3 During a search in another group of Gandhidham, engaged in stevedoring, clearing, forwarding and handling at the port of Kandla, small note books, in the nature of duplicate books of accounts were seized from the residence of one of the main persons. Bogus transportation and handling expenses were found debited in the names of 7 concerns from which false bills were obtained. The amounts paid to them by cheque were withdrawn from their bank accounts. In the statement *u/s* 132(4), it was admitted that (i) unaccounted cash is received from the Principals for clearing and forwarding work; and (ii) excess/ bogus expenses are claimed under the head handling and transportation for clearing and stevedoring work.

15.4 A racket was unearthed by the Customs & DRI authorities at Kandla port in which a Clearing and Forwarding agent at Kandla Port, and some brass scrap importers of Jamnagar, were involved. The Clearing and Forwarding agents become key persons in loading/ unloading operations of imported/ exported goods, as they develop strong liaison with the Customs and Ports functionaries, with whom they meet on day-to-day basis. Having won their confidence, some Clearing and Forwarding agents get involved in fraudulent practices, in the process earning large unaccounted incomes. During FY 1994–95 when the racket was unearthed the Customs duty on imported brass scrap was more than 100%. The Clearing and Forwarding agent got in touch with a few Delhi and Bombay exporters who were holding advance import licenses against export obligations, which entitled them to imports without payment of duty. The real importers of brass scrap of Jamnagar showed "high sea Sales" of their imports to these Delhi/ Bombay exporters, who, in their turn, cleared the goods without payment of custom duty at Kandla port on the basis of their advance import licenses against export obligations. The imported

containers were delivered directly to the brass importers at Jamnagar against cash payments of 65% to 70% of the payable duty in cash, to the CFA. The brass importers in turn, sold the imported brass scrap in black market, without bills.

15.5 In another search at Gandhidham in the case of another Clearing agent, clinching evidence of unaccounted payments to labour gangs of Kandla Dock Labour Board was seized. Under the Dock Labour Board Act, the stevedoring work/ work of shifting cargo from one warehouse to another, can be got done only through labour gangs supplied by the 'Dock Labour Board', for which labour charges are to be deposited beforehand, at prescribed rates. In the above case, the seized loose papers showed unaccounted labour payments exceeding Rs. 120 lakhs (as also corresponding receipts) during a period of about 6 months. Since these labour payments are in violation of the Dock Labour Act, they cannot be allowed as a deduction in view of the Explanation to Section 37.

CHAPTER 15

Medical Profession & Nursing Homes

1. GENERAL

1.1 Several systems of medicine are prevalent in the world. However, allopathy is by far the most acceptable system due to its global character, scientific system of examination and diagnosis based on continuing research on a worldwide scale. Its practitioners enjoy good status in the society and are assured of a decent income. Experience indicates that there is a large-scale tax evasion by medical professionals. Some cases where action *u/s* 132 or 133A was taken show that even leading professionals are disclosing only a fraction of their actual receipts.

1.2 The scale of evasion is illustrated by the case of a surgeon in a metro city, in whose case, papers found during a search revealed that though he was charging fees varying from Rs. 1,00,000/- to Rs. 2,50,000/-, depending on the financial status and the urgency of the patient but was disclosing only about 5–10% of his actual receipts. His receipts from some foreign patients were huge, but hardly any of these, was entered in the books. He was found to be in possession of unaccounted cash of Rs. 59 lakhs. Besides, evidence of large unaccounted investment in several immovable properties, and unaccounted expenditure on frequent foreign trips with his family members were also uncovered. He eventually admitted concealed income of more than Rs. 20 crores. In a case of an orthopaedic surgeon the search brought to light a novel method of suppression. Patient slips seized from his clinic revealed that as a matter of procedure, he used to enter receipts from only the first 5 patients in his books while the remaining 30 to 40 slips were destroyed every day. These examples are only a pointer to the massive generation of black money in medical profession.

1.3 In metro cities homeopathy medicine has also gained wide acceptance among the urban population, which has given rise to flourishing of practitioners of homeopathy medicine. The practice of homeopathy usually is done along with supply of medicines. So while investigating such cases attention should be paid to both the areas of fees being charged from patients and to the business of selling medicines.

2. SPECIAL FEATURES OF MEDICAL PROFESSION

2.1 It is difficult to verify the reasonableness of the income disclosed by medical professionals in absence of proper records and accounts of

their receipts/ expenses and their investments. It, therefore, becomes necessary to make a proper enquiry for making a reasonable estimate of income.

2.2 A sizable part of their receipts is in cash, which makes it difficult for an AO to verify the correctness of the disclosed receipts. Cross-verification becomes difficult in absence of documentary evidence and the tendency amongst rich patients to pay in cash and/ or from their unaccounted sources.

2.3 Doctors generally keep their accounts on cash basis, and claim that only cash realisations and cash outgoings should be taken into account. This allows them opportunity to postpone the taxability of receipts due but not actually received.

2.4 There are no fixed norms or standards for the scale of fees charged by a Practitioner. Fees vary depending on the locality, city etc. as also the professional competence, qualifications and experience of the doctor. Therefore, where a practitioner suppresses the figures of patients treated or the fees received from them, or both, quantification of income becomes difficult.

2.5 It is not possible for an AO to make a reasonable estimate of income without collecting data regarding the extent of practice of the doctor or his personal expenses & investments. Besides, it is quite possible that professional income may fluctuate from year to year, depending on several factors including competition, sudden outbreak of epidemics or unfavourable and favourable climates etc. This argument becomes a convenient handle to manipulate the returned incomes. Professionals, as a class, return higher incomes only in the year(s) in which they are required to account for some investments, or large personal expenditure.

2.6 Sometimes doctors are also paid in kind by affluent patients. It was noticed in some cases that the doctors were given expensive gifts by the patients or their families after the treatment. Detection of such 'receipts in kind' is not an easy task and their quantification all the more difficult. Sometimes it may be akin to a barter deal-medical professionals not charging anything from legal professionals for the legal services rendered by them and vice-versa.

2.7 A common occurrence in these cases is the diversion of the black money of the doctors to their family members and relatives through gifts including foreign gifts, agricultural income, stridhan etc.

3. CLASSIFICATION OF MEDICAL SERVICES

3.1 Family Physicians: General practitioners or GPs or family physicians is a popular group of medical men. They are the first contact point for a patient. GPs initially diagnose the ailment, refer the case to a Specialist and make house calls. They become family's friends, philosophers and guides during a medical emergency. They decide the stage when reference is to be made to Specialists, or a Surgeon or a Clinic for hospitalisation. Sometimes they also dispense medicines from their clinics. Their charges may vary from place to place and even locality to locality. Some families retain physicians on monthly or yearly basis. But most GPs charge fees on each consultation. Charges tend to be significantly higher during house visits, and visits during odd hours. Some general practitioners also charge commission from Specialists, Laboratories and Nursing homes. However, in metro cities a large number of GPs are also affiliated to large private hospitals where they also provide consulting time.

3.2 Specialists: Specialisations have come up in several medical fields–*viz.* Ophthalmology, Orthopaedics, Gynaecology, ENT, Nephrology, Oncology, Urology, Paediatrics, Dentistry, Neurology, Radiology, Cardiology, Dermatology, and so on. The 'Specialists' in

these fields develop lucrative practice after a few years of experience. Cases are referred to these specialists either by general practitioners, or patients directly approach them. Surgeons have income, both from consultation and from performing operations though a large part comes from operation fee. These specialists may be in employment of Government or other hospitals some of which do not permit private practice. Cases of Specialists having substantial private practice require special probe.

3.3 Super Specialists: A new category of Super-specialists is emerging because of the rapid advancement in medical sciences. Some recent super-specialties relate to Psychosomatic disorders; Immuno-deficiency disorders; Schizophrenia & delusional disorders; Delirium/ dementia/ sleep disorders; Muscular dystrophy & related disorders; Peripheral nerve disorders; Optic nerve and Retinal problems and disorders of conjunctiva; Eye-lid and tear gland disorders; Sports injuries; Electrical injuries, Children's congenital defects; Blood disorders; and mental disorders etc. There are also specialists in microsurgery; laser surgery; and transplant of organs. The private super-specialists charge very high fees. However, these specialists/ super-specialists also spend substantially on periodic updates, journals and magazines, familiarisation/ study trips abroad and acquiring latest equipments.

3.4 Hospital Consultants: The large private hospitals are of two types *viz.* corporate hospitals and hospitals registered as charitable trusts either *u/s* 12AA or 10(23C)(via). The doctors that serve these hospitals are either full time employee doctors or visiting consultants. In case of employee doctors, all the payments are routed through the hospital accounts and after TDS wherever applicable. However, for the visiting consultants the hospital may collect the fee on behalf of the consultant which thereafter gets remitted to the account of the doctor after TDS and other charges, and thus likely to be recorded in the accounts of the hospitals. The visiting consultants may also have an option where the consultant collects the fees from the patients directly in cash for which no receipt is likely to be issued unless the patient specifically asks for it. Similar is the case with the consultant surgeons who either collect their fees through hospital or directly from the patient, in cash.

4. LEGAL PROVISIONS UNDER IT ACT 1961

4.1 An activity carried on by an individual by his personal skill is a professional activity & encompasses the services rendered by him using that skill. Revenue receipts arising from exercise of a profession including the medical profession are chargeable *u/s* 28 of the Act even if they are of a casual & non-recurring nature. Earlier the main difficulty in correctly computing the income of the professionals was non-maintenance of proper books of account by them. Therefore, Taxation Laws (Amendment) Act, 1975 introduced Section 44 AA with effect from 01-04-1976, obliging medical professionals to maintain such records as would enable the AO to compute his income in accordance with the Act.

4.2 Rule 6F of IT Rules 1962 prescribes the books of account & records required to be maintained by certain medical professionals, under Section 44 AA of the Act. Section 44 AB requires that professional having receipts exceeding Rs. 50 lakh in any year will get their accounts audited and submit an audit report in the prescribed proforma.

4.3 Section 44ADA was inserted by Finance Act, 2016 w.e.f. A.Y. 2017–18, by virtue of which a professional whose gross receipt is less than rupees fifty lakh will not be required to maintain any books of accounts provided an income of 50% or more of the gross receipt is declared.

4.4 In the year 2009 the Medical Council of India amended the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, imposing a prohibition on the medical practitioner and their professional associations from taking any gift, travel facility, hospitality, cash or monetary grant from the pharmaceutical and allied health sector industries. In pursuance of this amendment the CBDT issued circular no. 5 of 2012 dated 01-08-2012, which stipulates that the claim of any expense incurred in providing above mentioned or similar freebees in violation of the provisions of Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 shall be inadmissible under Section 37(1) in the hands of such pharmaceutical or allied health sector industries or other assessee which has provided aforesaid freebees. The Circular also stated that the sum equivalent to value of freebees enjoyed by the aforesaid medical practitioner or professional associations is also taxable as business income or income from other sources as the case may be depending on the facts of each case. It must also be kept into consideration by the assessing officers that any practitioner who violates the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 may suffer consequence leading to cancellation of his/ her registration.

4.5 Finance (No. 2) Act 2014 has amended the Section 142A w.e.f. 01-10-2014. After the amendment the assessing officer may refer any case to the Valuation Officer to estimate the value, including fair market value, of any asset, investment or property for the purpose of assessment and reassessment. The assessing officer does not have to record a satisfaction or to reject books of accounts while making a reference to the Valuation Officer *u/s* 142A. Further, once such reference is made, the assessing officer has the advantage of abatement of assessment proceedings vide Explanation 1(v) to Section 153. This provision may be kept in mind while investigating cases of investments made by medical practitioners.

5. RECORDS NORMALLY MAINTAINED BY MEDICAL PROFESSIONALS

5.1 It is often seen that most medical practitioners do not maintain reliable and proper books of account. Some doctors maintain elementary books but these are not strictly according to accounting norms. Some keep diaries or slips but do not truthfully present them before the AOs. Records generally maintained comprise of the patient register or patient cards, appointment diary, receipt books, and a rudimentary form of cashbook.

5.2 However, with the advent of computers, most of the professionally organized medical practitioners maintain records of their patients on computers. Special computerized software packages allow medical professionals ready access to the medical history of their patients. Most of these packages also enable maintenance of record of appointments, as also accounts. These may, therefore, have all the information needed by the AO for verifying/ ascertaining the income. However, it is possible that for income-tax purposes the doctor may deny existence of these computerized accounting records.

5.3 Consumer Protection Act makes it obligatory for all hospitals and nursing homes to maintain registers of patients treated in their institutions. One such important document is the Operation Theatre (OT) register, which clearly bears evidence of the number of OT procedures performed by each doctor during any particular period. These records are kept by the medical institutions for a longer period even after the expiry of the financial year and normally nobody would take the risk of fudging such records.

6. DEVICES EMPLOYED BY MEDICAL PROFESSIONALS FOR TAX EVASION

6.1 Medical practitioners often not only suppress their receipts but also inflate the expenses and divert the incomes as would be apparent from following examples.

6.2 A pediatrician having a large practice in a major city was also running a pathological laboratory in the name of his wife. Information was received that the lady hardly had any proficiency to run the laboratory. Spot enquiries and examination *u/s* 131 of the Act confirmed that she was not even a graduate and hardly visited the laboratory. The building where the laboratory was located was shown as belonging to the assessee's mother-in-law who was being paid rent. On a sustained cross-examination the doctor admitted that the income of the pathology belonged to him, and that payment of rent was only to inflate the expenses.

6.2.1 Generally, the nursing homes are individual doctor centric. There is a tendency to employee family members. But most of the times, their salaries are not commensurate with the work. At times they don't contribute also but salary is paid to them on paper. These expenses are to be checked and verified in the light of provisions 40A(2)(b).

6.3 In another case a husband-wife doctor team was running a nursing home. The husband was a surgeon and wife a gynecologist. Both were examining their patients in the same nursing home and maintained a common Patients' register. The register had no column for charges paid by the patients. Statements of four patients were recorded by the Inspector. They categorically stated that they had each paid Rs. 500/- as consultation fee, and that the doctor was not issuing any receipt. During cross-examination, the doctor initially stated that there were no manipulations & and they were charging only nominal fees from the patients. However, when confronted with the statements of the patients, he admitted these facts. Ultimately both filed/ revised returns admitting much higher incomes.

6.4 The main allegation against a leading cardiovascular surgeon was that he was charging very high fees varying from Rs. 5 lakh to 12 lakh per patient in cash for performing heart operations. The fee was either not accounted or was only partly accounted in the books. It was also alleged that he was investing his unaccounted income in real estate & had purchased several immovable properties including agricultural land around the city. After discreet enquiry, a search was conducted, which resulted in seizure of unaccounted assets of more than Rs. 10 Crore. He was also found to have opened 17 bank accounts which were undisclosed and where unaccounted deposits of nearly Rs. 12.50 Crore were found.

6.5 A surgeon was attached with 2 nursing homes. However, in his return of income receipts from only one nursing home were being declared. During a survey *u/s* 133A papers found showed that he was working in two shifts in two nursing homes but was suppressing receipts from the second nursing home. His daily receipts were around Rs. 50,000/- to Rs. 75,000/- though disclosed receipts were not more than 40% of this.

6.6 A search was conducted in the case of a 'bone & joint' expert of 12 years' standing, running 3 nursing homes. It emerged that he had acquired a big farm house and 13 flats including two in posh areas of the city in benami names of his family members who hardly had any ostensible source of income. Though he was an orthopaedic surgeon, his nursing home was mostly frequented by Arab patients for rest. These patients used to be admitted in the nursing home for minor joint problems and small surgeries,

and used to be kept there for 10–12 days against room charges of Rs. 3,000/- to Rs. 5,000/- per day besides other incidentals. Payments for Consultation, Operation, and other surgical charges were mostly in cash. Scrutiny of bank pass books and account books revealed that his income during preceding four years varied from Rs. 1 to 2 crore per annum, though the returned incomes never exceeded Rs. 10 lakh. Most of the properties were acquired in benami names during this period against substantial cash payments to the sellers. Large unaccounted amounts were spent on renovations/ repairs outside the books of account. When confronted with this evidence he admitted that manipulation of books and admitted additional income as per the seized records.

6.7 Private Hospitals tend to inflate the capital expenditure. Corporate hospitals do it to reduce the profit and trust hospitals do it so that trustees can siphon off money from the trust. The amended provision of Section 142A can be very useful in such cases. In the case of one trust hospital the valuation report pointed out pilferage of few crores of rupees though the Department lost the case on technical grounds, as the case pertained to a period prior to the amendment to Section 142A.

6.8 It is also not uncommon that trust hospitals disguise the fees received as corpus donation from patients. The patient partly gains by claiming deduction *u/s* 80G and the trust has the advantage of having exemption *u/s* 11(1)(d), which means they don't have any obligation to apply such receipts. These facts can be checked by comparing similar cases in a hospital where the bills vary by a wide margin. If that is tallied with the list of corpus donation received, then *prima facie* the department will have a case that would be worth developing.

6.9 It is also common knowledge that some surgeons take part-fees in cash, directly from the patients which are not accounted for. The number and types of operations a surgeon has performed in a hospital can be obtained from the OT register. Charges for each operation can be ascertained from the accounted for entries or from the patient. Further the statement of the patient can be recorded and cross-checked with the claim that they have made with the insurance company or their employer, if applicable.

6.10 Many a times medical practitioners, especially specialists, refer their patients to other specialists and diagnostics Centres for consultation on specific issues. Many unscrupulous doctors resort to unnecessary referrals of patients for earning commission, which remain out of the tax net. There is likely to be records maintained for such activities but these cases can only be cracked during survey or search operation provided the search party knows what these entries mean. Commission on referrals by diagnostic Centres is the most common feature.

7. CHECKPOINTS FOR SCRUTINY

7.1 General: While taking up these cases for scrutiny, the AO should first ascertain the locality where the doctor's clinic is located; his professional qualifications, experience & expertise; and his standing, reputation and the type of clientele he attracts.

7.2 Professional Receipts: Since suppression of receipts is a very common feature in the cases of medical practitioners, it is necessary to ascertain the scale of fees charged by them from their patients for different types of services. The scale of fees will vary for different types of practices, e.g. General Physician, Specialists, Surgeons, and Consultants etc. It will also depend upon the type of facilities in the hospital/ clinic, where the services are being rendered. Therefore the AO should first find out:

a. The nature of services being provided by the doctor/ clinic, and the structure of fees for each of these services existing at the relevant time.

b. The amount of consultation fees charged from each patient. If the doctor is a surgeon, the normal range of fee charged for different types of major and minor operations. The fees charged in the cases of employees of Banks, PSUs, and such other bodies where medical expenses of employees are reimbursed by the Employers, can be a good evidence of the scale of actual fees being charged. The rates prescribed by CGHS for treatment of it's beneficiaries in private/ approved hospitals for various ailments, can be another good indicator. Similarly, fees charged in case of reimbursement of medical bills of different types by Insurance companies, e.g. in Mediclaim Policies can also be a basis.

c. In the cases of dentists, the fees for extraction, filling and other dental treatments etc. may be found. Some dentists specialize in Root-canal treatment where charges may be very high. Likewise some orthodontists specialize in other protracted dental treatments. It may be necessary to find out the exact fee-structure for each type of treatment.

d. In the cases of ophthalmologists, fee for consultations, for minor ailments, for cataract operations etc. can be ascertained. The fees are still higher for retinal, and other major problems. The branch in which the doctor specializes and the types of operations he performs can be ascertained. Charges may also vary according to the technique employed, e.g. laser techniques.

e. In all cases where surgical procedure is used under anaesthesia, the Surgeons obtain written consents of the patient or his relatives for carrying out the operation. These consent letters are usually preserved for long periods. These can give an idea of the number of operations carried out during the year.

f. Details regarding the attachment of the doctor with various nursing homes and private hospitals, as also retainer-ship with companies and public sector undertakings can be obtained, along with the terms of the contract

g. It is also useful to know the socioeconomic composition of the doctor's clientele, e.g. whether he is treating a large number of diplomats, foreigners, tourists, people from the upper income groups, as in such cases fees may be very high.

7.3 Based on the above information relating to the nature of practice, the professional standing/ reputation of the doctor, the composition of his clientele, the volume of his practice, the number of patients that he examines per day on an average, and the nature of services provided by him, it should be possible to make a reasonable, though rough estimate of the likely annual receipts of the doctor.

7.4 Professional Expenses: As regards the reasonableness of the professional expenses claimed, it may be useful to obtain the following particulars:

a. Rent, Rates, Taxes and Insurance.

b. Expenses on water, electricity, cleanliness and maintenance, and security.

c. Telephone & digital expenses.

d. Expenses on papers, magazines, technical journals, TV and Internet.

e. Salary or other payments to clinical staff e.g. Consultants, Anesthetists, Radiologists, Blood bank, junior doctors etc.

f. Expenses on membership of Professional associations, medical conferences, foreign trips, etc.

7.5 Personal Expenses and Investments: Since definitive checks are not possible on the actual professional earnings, particularly in cases where proper books of accounts are

not maintained, in a case where the disclosed income appears to be grossly inadequate, it may be advisable to examine the outgoings in respect of personal expenses and investments, and verify their reasonableness. For this purpose, a breakup of personal expenses can be obtained in respect of:

a. Rent, taxes, Society charges, electricity and water bills for residence
b. Expenses on cars, drivers etc.
c. Expenses on children's education including tutor's fees
d. Salary to servants, chowkidars and other domestic aids
e. Travel and holiday expenses-both inland & foreign
f. Expenses on entertainment, Club fees, hotel bills etc.
g. Expenses on PPF, LIP contributions, Medicare premia, tax payments etc.
h. Gifts/ donations exceeding Rs. 10000/-
i. Expenses on Credit Card payments.
j. Expenses on purchase of expensive Consumer Durables.
k. Expenses on major functions, ceremonies, marriages etc.
l. Expenditure, if any, on purchase/ construction/ repairs/ interior decoration of house.
m. Particulars of new investments in shares, fixed deposits, and other movable property.

7.6 Bank Accounts: Though part of black money earned by doctors & other professionals may be spent on lavish lifestyle a part may indirectly find way to bank accounts of the doctor, his spouse and children etc. Therefore, scrutiny of bank accounts often leads to discovery of vital clues enabling an AO to collect sufficient evidence of unaccounted deposits transfers, interest etc. Detailed guidelines for examination of bank accounts have been discussed in Volume I of the Manual, and may be referred to.

7.7 Statement of Total Wealth: Another useful tool of investigation in these cases is the power available *u/s* 142(1), to call for the statements of total wealth as at the beginning and at the end of the accounting year. The AO can then examine the accretion in wealth, and the personal expenses with reference to the disclosed income. Detailed discussions regarding the calling of the statements of total wealth, and their examination have also been made in Volume I of this Manual, and may be referred to.

8. NURSING HOMES

8.1 During the last three decades private nursing homes, maternity homes and polyclinics have mushroomed in all big and small towns. Huge investment is made in constructing and equipping these private nursing homes, which are constantly upgraded and expanded. Some of the nursing homes are as big as mini-hospitals with excellent surgical and nursing facilities. They normally maintain Admission register; Births and deaths register; Receipt book; ; Day book; Cash book; Ledger; and Salary register etc., besides the records of the patients. On the basis of these records, a Receipt and Expenditure statement can be drawn.

8.2 Verification of Receipts: Details relating to preliminary consultations, room charges, various Pathology tests/ X-ray charges, charges for Anaesthesia, Charges for Consultations with other experts, Pre and Post-operative charges, Operation fees and charges for medicines, and charges for blood transfusion etc., must be closely examined. Maternity homes are, by law, required to give intimation of births, and deaths at their premises to the municipal authorities under the Registration of Births and Deaths Act. The statutory records maintained under this Act can give valuable information regarding the number

of maternity cases handled in a year. Similarly under the Medical Termination of Pregnancies Act, the maternity homes are required to maintain records relating to the abortions carried out at their premises. Prominent nursing homes in important towns are approved by various Public Sector Undertakings, Private Limited Companies, for treating their Directors/ Senior Executives. Details of payments by the PSUs/ Companies can be obtained from these concerns and cross-verified with the statements submitted by the nursing homes. The rate structure of charges in these statements can be used to verify the reasonableness of receipts shown from other patients.

8.3 Verification of Expenses: Details of expenses on Rent, Rates & Taxes; Society charges; Expenses on laboratory; charges on Technicians; Salaries; Laundry charges; Expenses on running and maintenance of vehicles/ ambulance; Payments to associates; Expenses on medical journals, magazines; Misc. charges like postage, stationery, computer/ internet etc. can be called and verified. The genuineness of payments to associates, other Specialists, junior doctors, nurses etc. should be checked carefully with respect to their terms and of their engagements.

8.4 Investments: The investment in construction of the nursing home and purchase/ installation of costly equipments must be critically examined. There is a tendency to understate the investment in purchase of land and construction of building to overcome the difficulty of explaining the source of investment. On the other hand,-expenses incurred on air-conditioning, special fitting/ sound proofing and in purchase/ installation of expensive equipment/ X-ray machines etc. is overstated to avail higher loans from Banks, and higher depreciation. Therefore, these should also be properly looked into. Often owners/ trustees of nursing homes connive with the suppliers/ manufacturers of costly equipment/ X-ray machines and manage to procure fake/ inflated bills

8.5 Very often the involvement of family members is so skillfully planned that in the first instance it appears genuine. The devices mentioned below need to be carefully looked into to ascertain the genuineness of such claims:

a. Showing the spouse of the assessee as the owner or main tenant of the building from where the clinic is run, and paying inflated rent to such ostensible owner.

b. Showing the spouse or a relative as the owner of a Pathology or a laboratory, or a medicine shop, or an expensive machine, or an expensive service e.g. ambulances, needed by the Nursing home, and paying inflated charges to such concern.

8.6 Bank Accounts: While investigating cases of private nursing homes Bank passbooks of the owners/ doctors and their family members may also be examined. Detailed guidelines for examination of Bank accounts have been given in Volume I of the Manual, which may be referred to. In serious cases of tax evasion, Total Wealth statements of the main owners can be called, as discussed in Para 7.7 above.

8.7 Verification of Billing of Rooms at the Time of Discharge of Patients: At times, at the time of discharge of patients there is a tendency to leave the patients after 12:00 Noon so that billing can be made for another day. In this manner, billing is made for two patients for the same day but in the books only one is billed. This idea is also being used in the Hotel Industry where capacity utilization is more than 100%. In this regard the discharge timing should be thoroughly verified.

9. DIAGNOSTICS CENTRES

During last few years a number of Diagnostics and fitness centres have been

setup with 'state of the art' medical facilities and expert team of consultants. The concept, which is borrowed from foreign countries, is of 'one-stop-shop' for primary health care, diagnostics & fitness. They provide facilities like-Medical & surgical consultations; Health screening; Pathology; Radiology & Imaging; Physiotherapy; Dentistry; Hoemodialysis; Yoga & Stress management etc. While examining such cases proper enquiry should be made regarding the reasonableness of the investment shown and the sources of investment. Particularly, the first year of setting of Diagnostic Centres and Nursing Homes is crucial, as the surplus amount of black money generated is invested in creating the physical infrastructure. It is necessary to obtain a list of the services provided by various doctors/ experts attached. The AO should also obtain the list of major equipments installed, and examine the source of investment in the same, as these ultramodern health centres are often setup to invest unaccounted funds.

CHAPTER

16

Other Professions:

Other than Medical Profession

1. GENERAL

1.1 The idea of valuation of human resource material i.e. skilled individuals and professionals in the financial statements is just gaining acceptance. A 'profession' is defined as a commercial practice or exploitation of one's individual skill, which can be across a large number of activities required by a particular Section of society at a particular point of time. With the globalisation of economy and the new trend of professionalization of services, professionals are entering into new areas moving away from their traditional roles of medical professionals, advocates, legal advisors etc.. Therefore, there is increasing demand for professional fashion designers and models, jewellery designers, singers, industrial consultants, valuers, financial analysts, interior decorators, event managers, public relation consultants, private detectives, script-writers, Vastushastris, software consultants, and so on.

1.2 There is a boom in services sector of the economy, which is providing new opportunities to these 'skilled individuals'. It is also a fact that service sector contributes a very large proportion to the over-all black economy. Investigation in the case of professionals pose an altogether different kind of problem than those arising in the case of a trader or manufacturer, as the backward and forward linkages of the activities of professionals with the clients to whom services are provided is not readily available.

2. SCOPE OF PROFESSIONAL INCOME

2.1 Under Section 2(36) of the Act, the term 'profession' has been given an inclusive definition, to include vocation. Generally, 'profession' is an occupation requiring either purely intellectual skills, or some special manual skills of the operator. Therefore, exercise of professional skills is to be distinguished from operations involving production or sale of commodities. It is often said that, "all professions are business but all businesses are not professions". There are some subtle distinctions between the terms 'business' and 'profession', namely:

a. While 'business, involves production or trading of a commodity or goods, no such items are required for profession. A profession is basically commercial exploitation of one's skill and knowledge.

b. In 'profession', the capital requirement is either low or nil; while in a business 'capital' is one of the major input.

Thus, professional activity can be understood as an activity carried on by the individual by his personal skill and intelligence, to offer specialised services to his clients.

2.2 In theory, a 'profession' can be carried out by an individual alone or by a group of individuals. All the revenue receipts arising from the exercise of a profession are chargeable *u/s* 28 of the Act, even if they are casual and non-recurring in nature. Payments voluntarily made by persons, who are under no legal obligation to pay anything at all, would be income in the hands of the recipient, if they were received in the course of exercise of profession. Therefore, an amount received by a lawyer from a person, who was not a client but who had benefited by the lawyer's professional service would be taxable in the former's hand. Similarly, shares gifted by clients to a lawyer who had assisted in, say floating a company, would also be taxable in the latter's hand.

3. PROBLEMS IN DETERMINING PROFESSIONAL INCOME

3.1 The main problem in determination of professional income is the difficulty of verifying the correctness of the disclosed income because these persons generally declare their income on estimate basis and do not maintain adequate records of their income, expenses and investments.

3.2 Another problem is the possibility of large fluctuation of annual incomes from year to year. This provides them considerable scope to manipulate disclosed incomes, and to disclose larger income in the year in which some investments are made while getting away by disclosing smaller incomes in other years.

3.3 Professionals, by and large, keep their accounts on cash basis, as per which only cash realisations and cash outgoings are taken into account. This allows them considerable flexibility in postponing taxable receipts to a later year depending upon the cash flow situation.

3.4 A very large part of professional receipts are generally in cash. This is further compounded by the fact that their clients also generally prefers to make payments in cash from their unaccounted income. Cash receipts can be easily concealed by simply not recording them in the regular books of account and the detection of the same is extremely difficult.

3.5 The fees charged by the professionals vary widely, depending on the qualification, competence, and popularity of the professional, as also on the,paying capacity, relationship and standing of the client. For instance, in the case of Architects the fees may range from 0.5% to 10% of the total cost, depending on the size of the project, the standing of the Architect, and his relation with the builder. Such a situation offers a large scope for manipulating and understating theirprofessional income.

3.6 Many a times professionals, like Advocates also act as 'retainers' for which they get, a fixed amount of fee, as also perquisites in the form of rent-free/ furnished accommodation, and/ or some other facilities. They also charge fees separately for appearing in the cases before various courts. The value of these perquisites and the full fee charged for such representation are at times not disclosed to the Department.

3.7 Professionals often spend large amounts on lavish lifestyles and conspicuous consumption to increase their clientele network, as also out of sheer compulsions of their professional activities. While the traditional professionals like lawyers, architects etc. may fall in the former category; the new breed of the glitterati world like fashion gurus, pop singers, actors/ actresses, and models etc. flaunt lavish life styles due to their professional demands and to profess that they are successful. Therefore, it becomes necessary

to ascertain their lifestyle, personal expenses, investments etc. of the professional tax payers.

3.8 Another problem common to all professionals is of artificial diversion of income in the hands of near relatives, nominees & benamidars etc., and its subsequent capitalisation in their hand. This is done by taking recourse to various escape routes, such as gifts including foreign gifts, agricultural income, streedhan, fictitious 'wills' of deceased relatives etc.. Some novel methods include relinquishing of rights in shares in favour of close relative, and bartering assets at understated costs. Therefore, it becomes necessary to examine the creation of wealth in the hands of the relatives/ benamidars etc.

3.9 Every profession has its own distinct modus operandi, ambience and ethos depending upon the Section of society, it is catering to. During an action *u/s* 132 against some fashion designers at Delhi, their professional records and accounts were found to be in a state of complete disarray. It emerged that they hardly had any time or inclination to pay attention to such mundane things, like their financial accounts & records.

4. PROVISIONS OF IT ACT

The main hurdle in correctly computing the income of professionals is the absence of proper maintenance of the books of account by a professional. For this very reason, Section 44AA was inserted by the Taxation Laws (Amendment) Act, 1975 with effect from 1-4-1976, making it obligatory for persons engaged in specified professions to maintain such books of account, as may enable the AO to compute their income under the Act. Further, Section 44AB of the Act requires a professional having gross receipt of Rs. 50 lakhs and above, to get his accounts audited. The audit reports, wherever available, become an important tool of investigation. However, in most cases these statutory norms are not complied with. Therefore, by and large the cases of professionals have to be investigated not only with the help of accounts produced by them, but with reference to information of their professional activities, life style, expenses and investments gathered from different sources.

5. LEGAL PROFESSION

5.1 The legal professionals may broadly be categorized as Lawyers, commonly called Counsels, Solicitors, or Advocates-on-record in the Supreme Court. The Advocates Act, 1961 regulates the legal profession. The Bar of the Supreme Court is divided into three categories, *viz.* Advocates-on-record; Advocates other than Senior advocates; and Senior advocates.

5.2 Senior Advocates: Section 16(2) of the Advocates Act provides that an advocate may, with his consent, be designated as Senior advocate if Supreme Court or a High Court is of the opinion that by virtue of his ability, experience and standing at the Bar, he is deserving of such a distinction. The pleading advocates, other than senior advocates, whose names are entered on the Common Roll, come in this category Junior advocates.

5.3 Solicitors: The primary function of a Solicitor is that of an agent for litigants whose cases have gone before the High Courts. Under the rules of procedures of the Calcutta and Bombay High Courts, no Barrister or Advocate can be engaged to plead a case before the High Court on the original side, unless he is instructed by a Solicitor. In other words, where a litigant wants to file a suit before these High Courts, a Solicitor has to be engaged. The Solicitor's work includes drafting of petition, consultation, settling of petition, and such other miscellaneous matters. They also often work as Liquidators or Receivers, give legal advice or obtain it for their clients, and handle legal aspects of setting up new companies, issue of debentures, underwriting of shares etc.

5.4 Advocates-on-Record: The Supreme Court rules prescribe that no person other than an Advocate-on-record can appear and act for a party and no advocate can appear for a party at the hearing unless he is an Advocate-on-record

or is instructed by an Advocate-on-record. Rule 6 (c) of the Supreme Court Rules 1966 lays down as under:

"Every advocate-on-record shall keep such books of account as may be necessary to show and distinguish in connection with his practice as an advocate-on-record, (i) moneys received from or on account of and the money paid to or on account of each of his clients; and (ii) the moneys received and the moneys paid on his own account".

5.5 The Sub-rule (d) of Rule 6 lays down an important condition, namely:

"Every advocate-on-record shall, before taxation of the Bill of Costs, file with the Taxing Officer a Certificate showing the amount of fee paid to him or agreed to be paid to him by his client."

5.6 Thus, the duties of an advocate-on-record are similar to those of the Solicitor. They charge fees for consultation, drafting petitions, settling petitions by the Senior Counsel, and filing papers in the Court, and collect lump sum amounts to defray expenses. The Solicitors and advocates-on-record generally maintain Cash Book; Clients' ledger, Bills register; and Journals.

5.7 An important issue needs mention here. While in the weekly or fortnightly cause-lists issued by the High Courts, the names of the both Solicitors and/ or lawyers who represent the litigants are mentioned, the cause-list of the Supreme Court gives names of only the Advocates-on-record, who alone can furnish the name of the Counsel appearing in a particular case. It is, therefore, necessary that a list of fees paid by an Advocate-on-record to different Counsels on behalf of his clients be obtained for verifying the receipts shown by an advocate.

5.8 Checkpoints for Scrutiny

a. A complete list of cases in which the lawyer appeared before different courts, as also other cases handled by him during the year, can be obtained from him. Receipts from important/ major clients can be verified.

b. Solicitors can be asked to give complete list of lawyers engaged by them on behalf of their clients along with particulars of payments made to them.

c. Weekly/ fortnightly/ monthly cause-lists of the High Courts can be obtained in cases of senior lawyers/ solicitors where concealment is suspected. As these lists contain names of the solicitor/ advocate connected with each case, these provide valuable information for cross-verification.

d. The terms and conditions of retainerships, including discontinued retainerships, if any, can be examined.

e. Particulars of other part-time activities and remunerations there from, such as part-time lectures in law colleges and valuation of answer sheets; appointment as receivers/ commissioners, arbitrators; giving opinions, arranging negotiations/ out of court settlements etc., can be verified.

f. In the cases of advocates handling high profile/ sensitive cases, discreet enquiries can be carried out, particularly where there is information regarding huge pay-offs/ package deals etc. In such cases, information could be forthcoming from the rival. Many times high profile and sensitive cases continue for years and lawyers maintain separate accounts of such cases. These accounts should be closely scrutinised to find out whether advances shown as liabilities are actually final receipts. The expenses (debits) may be also overstated or fictitious.

g. Juniors/ Subordinates working under senior lawyers may have vital information about the extent of receipts and high profile cases handled, during the year. Many a time remuneration to juniors is overstated to reduce the taxable income.

h. Money deposited in the bank accounts of solicitors/ Advocates-on-record and

claimed to be deposited by clients is often advanced for services to clients (including fees for senior advocate, solicitor, clerkage and other incidentals). The veracity of such deposits needs to be closely examined, as these may be unaccounted money of the solicitors/ advocates.

i. Remunerations from services such as for floating new companies, negotiating sale of controlling interest in a company i.e. takeover deals of corporates, can be verified.

j. Sometimes interest, which may not at all relate to the professional activities of the lawyer, is debited to the accounts. Similarly, depreciation may be claimed in respect of items not connected with the professional activities. While such amounts will have to be disallowed, a scrutiny of the accounts and the depreciation claimed may also give clues to the unaccounted investments.

k. In recent times, finance professionals also handle work of multinationals and sometimes services are rendered abroad for offshore clients. Taxability of this income will be as per existing law. Since global income of the individual is to be taxed, the AO should examine this angle.

6. CHARTERED ACCOUNTANTS & TAX PRACTITIONERS

6.1 Chartered accountants have basically two specialisations-auditing and taxation. The functions of the Tax practitioners and tax consultants are, of course, limited to taxation only. Besides auditing accounts, Chartered accountants also attend to taxation matters of their clients. The checks elaborated with regard to the legal profession are also applicable to this class of professionals. However, the Chartered accountants and Tax practitioners mostly have a permanent clientele, in contrast to the members of the legal profession, who have a shifting clientele. Therefore, it is relatively less difficult for an AO to get the details of clients of each Chartered accountant or Tax practitioner.

6.2 Some typical checks to be carried out by the AO in these cases are, as under:

a. Full list of cases can be obtained, showing the fees received by the Chartered Accountant for statutory audits, for other audits, and for representation of the client in income-tax, Sales Tax and other quasi-judicial proceedings.

b. In the case of a Tax Practitioner, list of payments received by him in connection with the preparation of returns of income and appearances on behalf of the clients in Income-tax/ Sales Tax matters can be obtained.

c. Important particulars from these lists can be crosschecked with the corresponding details obtained from the concerned clients. Often Chartered accountants and Tax Practitioners are also engaged as retainers by reputed concerns. The terms and conditions of such retainerships can also be called for and examined.

7. ARCHITECTS

7.1 In the case of Architects also, the clientele changes from time to time. For example, once a particular project designed by an Architect is complete, chances are that need for his services may not arise to that client at least in the near future.

7.2 Following points may be kept in mind in these cases:

a. A substantial part of unaccounted money is consumed in real estate investments. Since the fee of an architect depends on the size and cost of the project, a portion of the Architect's fee may also remain unaccounted.

b. Many architects are also Registered Valuers. It must be seen whether the fees

charged for valuation work have been properly accounted for or not. Often extra fees are charged by these professional for understating the valuation of a property.

c. Many architects are known to take money from contractors for certifying the quality of the work of a carpenter, a plumber, an electrician or a civil contractor, which is usually a certain percentage of the project cost that he is certifying.

d. Inflation of expenditure, which is common to all professionals, is equally rampant in the cases of architects. For example, an architect may claim that he had paid certain percentage of his fees to structural/ electrical/ plumbing designers, though in actual fact he may not have paid any such amount at all, or might have paid a lesser per centage. Inflation of salary to staff (e.g. Draughtsman) is another mode of understating the income.

8. AUTHORS, ARTISTS AND MUSICIANS

8.1 Uncertainty of Career: It is an admitted fact that popularity of these professionals is of a fleeting nature, depending on passing taste, whims and fancy of the public. As a result, their careers fluctuate with popular demand, and are generally short-lived. Not unnaturally, therefore, these people make efforts to earn as much as possible in the short time in which their popularity is high. Therefore, they are often tempted to declare only a part of their income. Even where they wish to declare their true income, the persons making payments to them prefer to make payments out of their unaccounted income.

8.2 The Department's experience in the cases of many established artists is that they do not maintain any books of account. They generally file statements of receipts and expenses only. Many times omissions of receipts have been detected in such statements. For ascertaining the receipts of established film artists etc. up-to-date information regarding their work will have to be gathered from as many sources as possible. Trade journals are of great help in this regard.

8.3 In the case of reputed singers, musicians and authors, it is necessary to ensure that the royalties received by them from the recording companies/ publishers on the sale of their discs/ publications etc. are properly disclosed. Famous musicians are also in demand for giving music concerts locally as well as in foreign countries. There is a tendency to suppress the income from such programs, including the travelling and hotel expenses received. Efforts should, therefore, be made to obtain the details of such payments from the organisers of the programs.

8.4 Most authors do not keep proper books of account. It is, therefore, necessary to verify the disclosed receipts with reference to the information collected from the publishers. In significant cases, the AO may obtain extracts from the catalogues of major publishers which give details of books including the name of the author, publisher etc. The information collected could then be verified with reference to the receipts disclosed by the author.

8.5 Royalty received from the publishers/ recording companies: The receiver normally accounts for the Royalty on receipt basis, while the Publisher books expenditure on accrual basis. It cannot be denied that whenever an expenditure is booked by the payer, the same can be treated to have accrued in the hands of the recipient, regardless of as to whether the same has been paid or not. Hence, in the case of publisher/ recording companies having paid/ booked significant amount under the head "Royalty", it might be proper to cross-check the amount shown by the author/ musician via-a-vis the accounting treatment adopted by the publisher/ recording companies.

8.6 On many occasions, expenditure on tour like air-fare, hotel charges, charges for the musicians who accompany them, and other incidental

charges are paid by the organizers directly to the persons who raise bill for these expenses. Normally, the accounts are not credited by the amount of reimbursement received since per se, these do not constitute income. However, even then, the expenses may be claimed as deduction in the accounts. This must be kept in mind while scrutinizing the claim of such deduction.

8.7 The eminent singers plan their tours in a fashion that on a trip, more than one concert is staged. However, most of them charge the expenses like Air-fare, Hotel charges, Charges for the musicians, incidental charges etc. from all the organizers and such payment is normally received in cash. The reimbursements received are either not disclosed at all, or, at the most single reimbursement is disclosed. Therefore, the receipts from all trips with significant duration are to be verified from this angle and reference may be made to the organizers, if required.

8.8 On many occasions, the receipts from concerts/ stage shows/ private shows are suppressed, either partially or fully, depending on the nature of receipt from such organizers. The main auditoriums of the city where the artist has toured for a considerable length of time may be contacted for details of programmes held during that period for ascertaining as to whether any programme of the artist concerned was held there. From the said list also, organizers can be traced out for verification.

9. RACE HORSE TRAINERS AND JOCKEYS

9.1 As per the rules of the Turf Clubs in general, they maintain detailed accounts of both, the trainers and Jockeys in relation to payments made to them by racehorse owners, in respect of the horses maintained in their stables, and for the races conducted in the race course of the club. The clubs also maintain accounts of the amounts receivable from other clubs in case, a horse from their stable enters in a race conducted by an outside club. Therefore, the income declared by Jockeys/ trainers can be verified from the turf clubs.

9.1.1 Trainers: Trainers normally receive:

a. **Basic Training Fees** paid by the owners of the racehorses. This varies from season to season as per rates fixed by the parent Turf club;

b. **Commission from Racehorse Owners** is paid as perthe rules of the Turf clubs, as a percentage of the prize money on the winning horses as well as for horses 'placed' upto 3rd position in a race of 7 horses and upto 4th position in races of 8 or more horses. The exact percentage of prize money can be ascertained from the concerned Turf club; and

c. **Percentage of Cup Value** as per rules of the concerned club is also given to trainers.

9.1.2 While dealing with cases of the Trainers, the AO should check the expenses claimed by them. Most of the Trainers claim large expenses on horses in the races conducted by other Turf clubs. These include transport of horses, maintenance of horses at the outside club, stable rent, etc.. It is essential to verify the Club certificates to ascertain the exact position. Some of these clubs as well as the parent clubs generally, subsidise transportation cost and the stable and maintenance expenses in respect of horses participating in such races. Often the horse owners bear most of such expenses. Generally, the trainers are not expected to bear the expenses outside the parent club premises.

9.1.3 As regards the receipts of the trainers, it is essential to verify the Club's circulars relating to the particular race and the 'Racing guide', for determining the quantum of owner's commission as also the percentage receipt of the cup value. In the case of a trainer who is also the owner of race horses, it will be necessary to examine both the accounts carefully, especially the amounts

receivable by him, under the Club rules, as Trainer of his own horses.

9.2 Jockeys

9.2.1 Jockeys receive amounts from the owners as per the rate fixed by the parent Turf club, from the following sources:

a. **Riding Fees** is received from the owner directly, or through the club, irrespective of the fact whether the horse ridden by him wins or loses.

b. **Commission from Owners** also goes to the jockey of a winning horse. The jockey receives 10% and 7.5%, of the prize money, for riding a horse placed first or second, respectively. In respect of other horses "placed", his share is 5% of the prize money. However, the jockey does not receive any amount in respect of the cup value.

9.2.2 A jockey cannot claim expenses against his professional receipts except as specified in the statute *viz.*, for insurance, transport etc. As in the case of Trainers, it is essential to cross-verify the declared income with reference to the accounts maintained by the club.

9.2.3 Apart from, the payments regulated by the rules of the Turf Clubs, detailed above, there are other receipts also. It is well known that Trainers and Jockeys receive substantial extra payments from the owners on certain occasions. These are gratuitous payments especially when races are "fixed". It is also commonly known that the owners of horses share a part of their stake money with both the Trainers and Jockeys. It is learnt that in respect of "fixed" races heavy odds are offered and Trainers and Jockeys also share the earnings. "Joint Ventures" between Jockeys or between Trainers and Jockeys are also not uncommon. It may be noted that turf clubs do not permit Trainers and Jockeys to bet or act as ordinary punters.

9.2.4 The usual method adopted for concealment by these professionals is not to show the receipts other than those permitted by the Clubs. In the case of Trainers, the expenditure account relating to horses entered in races conducted by outside clubs need scrutiny and verification.

10. INTERIOR DECORATORS

10.1 Some architects also do interior decoration work. But there are professional interior decorators also, who specialise in lifestyles and ambience. These professionals are concentrated in metropolitan cities where space constraints and the desire to lead aristocratic lifestyles go together. Many interior decorators operate through Architects.

10.2 The clientele of the interior decorators is generally developed through personal contacts and recommendations, which may not be on records. This renders the traditional methods of investigation of books of account, ineffective. Therefore, ascertaining particulars of clients to whom services were provided during the year is a difficult exercise. However, names of the architects are on the record of builders. The reputation of architects also contributes to the market price of the project.

10.3 The scope of the work of an architect is visible through exterior structures, while the work of the interior decorator remains behind doors. Unless one enters the house, it is difficult to ascertain the cost or the quality of the interior decoration. This enables the interior decorators to operate on cash basis. Both, the cost of interior decoration, and the charges of designer are generally paid from unaccounted money. Naturally, therefore, the interior decorators also do not offer for taxation, such receipts in their books. Therefore, the AO has to focus on personal expenses, investments and bank accounts, rather than receipts.

10.4 The fees charged by interior decorators are often exorbitant. In most of the cases, it exceeds

10% of the cost of renovation. In mega cities, such as Mumbai, often the cost of renovation exceeds the cost of the flat itself. In an action *u/s* 132 of the Act at Mumbai, it was noticed that a particular businessman had spent more than Rs. 2 crores on renovations, while the cost of the flat was much less. The cash component in renovations was found to be more than 60%. In nutshell, these professionals have large earnings which is away from the public gaze.

10.5 Many well-known interior decorators are not even assessed to tax. In these cases, the Architects provide the crucial links. In majority of cases, the interior designer operates through the Architects. Therefore verification from the architects about the particulars of the interior decorator engaged may yield valuable information.

11. FASHION DESIGNERS AND MODELS

11.1 These are a new class of professionals operating in the glamorous Section of the society. This is a field where money is intrinsically associated with the fame of a person. Therefore, there are a large number of entrants, mostly upcoming and upwardly mobile youth, operating mainly in the black segment of the economy.

11.2 The factors contributing to the rapid growth of these professions are the widespread industrialisation, urbanisation and growth of consumerism. The fashion and garment industry has grown exponentially, benefiting the 'designer houses', and the in-house designers. Today, leading chains of garment stores and brand movers in the garment industry are having in-house fashion designers and consultants. People like film celebrities, sports star, industrial icons, models, film producers etc. are ready to spend huge sums for acquiring a different look.

11.3 The relation between 'models' and fashion designers is akin to that between an actor and the director of a film unit. Models are the mainstay of the fashion-designing world. Therefore, with the advent of fashion designing, modelling has also become a full time profession. Modelling has a wider scope than fashion designing. Modelling is intricately related to growth of consumerism and brand advertisement culture. Several advertisement companies have exclusive models, for their assignments.

11.4 In the case of modelling, generally there is a "contract" for certain period of time during which the model has to work for the "Agency", depending upon of the terms and conditions. The receipts of models, from the Agencies, are by and large, properly verifiable because the "Agency" has to claim the payments made to models, as expenditure in its own case. Therefore, inflation of expenses is a more common mode of suppression of taxable income in these cases. It is however, possible that a particular model may have worked for several assignments with several Agencies. In such cases, it may be necessary to ensure that all receipts are accounted for.

11.5 The profession of 'fashion designers' is an exclusive field where, generally, considerations are kept confidential. For example, how can one ascertain the amount charged by the designer for the winning designer costume of say Miss Universe or any other pageant? Therefore, in the case of these professionals, their life style, consumption pattern and personal expenses need to be thoroughly scrutinised. For instance, these professionals often travel abroad to participate and/ or attend foreign fashion shows and exhibitions etc.. Therefore, expenses on foreign trips can be an area of scrutiny.

11.6 The professions of modelling and fashion designing etc.. are relatively new. Very often, these professionals are ignorant of their obligations under the tax laws, particularly relating to maintenance of record. Therefore, the AO must try to collect outside information, such as market and media reports in glamour periodicals and collect data regarding prominent fashion shows and exhibitions etc.

12. PAINTERS, SCULPTORS AND FINE ARTISTS

12.1 Painters, sculptors and fine artists usually market their art work to individual buyers, to art galleries and may also work on commissioned projects, particularly in film and television industries. Artists may also maintain their own studios. Overseas exhibition is also a source of income. Income is mostly generated in cash and only a part of income is disclosed in the Income-tax Return. Expenses are also incurred in cash and there is tendency to inflate expenditure to reduce tax liability. Books of accounts are not properly maintained.

12.2 In the case of these professionals it is very difficult to ascertain manpower input and output therefrom. There is need to collect information from exhibition houses, art gallery owners, media including social media and art journals etc. Credible information may be collected by conducting survey in artist's studio which may lead to detection of unaccounted income.

13. SPORTS PROFESSIONALS

13.1 In Indian standard, players, coaches and support staff of a team are included in this category. The country is known for sports like football, cricket, hockey, kabaddi, badminton, chess, snooker etc. but now, the most popular sport is cricket.

13.2 Cricket players earn more than other players. Cricketers are categorized by the parent body BCCI and are paid as per Central Contract, which includes retainer fees, fees for Test/ ODI/ T-20 matches, team performance bonus for a match/ series/ tournament including IPL and individual performance bonus. There is also income from respective club/ franchisee. They have huge income from media advertisements and endorsements and also from sponsors.

13.3 Income of players and sport personnel associated with other sports including football are not so lucrative as compared to that of cricketers. Apart from income from Central and State bodies for national and international matches, they have income from clubs and franchisees and from tournaments like I-league, ISL, Pro-kabaddi, Badminton League etc. and from advertisement campaigns.

13.4 Like other professionals, sports personnel also evade tax by under reporting income and inflating expenses. Unaccounted income is usually spent in lavish life style, acquisition of wealth and exotic tours and travels.

13.5 Examination of contractual agreements/ documents of similar nature is absolutely necessary in assessments of sports professionals. Reference to the clubs, franchisees, sponsors, agents, corporate houses, media and publicity agencies associated with advertisements should also be made to gather information about income. Form 26AS, Bank statements including credit/ debit cards, passports are required to be scrutinized thoroughly to obtain clues of unaccounted income, expenditures and investments.

14. PROFESSIONAL ENGINEERS

14.1 Professional engineers are usually deriving income from providing professional services, such as engineering, consultancy, drawing & designing, procurements and project management etc. Rampant tax evasion is prevalent in this class of professionals by suppressing income and overstating expenses.

14.2 During assessment, the AO should examine the document of contractual agreement/ professional agreement to ascertain the income components embedded therein and compare the same with ITR. Detailed project schedule, critical activities/ services rendered, involvement of other parties/ agencies, inputs and logistics provided are required to be examined to identify any hidden income.

14.3 'Contract for service' or 'contract of service' is a controversial issue in this profession.

The former is chargeable *u/s* 28 as professional income but the later is chargeable *u/s* 15 as income from salary. Therefore, it is essential to examine the related agreement critically to determine the correct head of income.

14.4 The AO should examine whether the engineer is working in single capacity or working as consortium of other service providers like interior designers, man power suppliers/ labour and other contractors, material suppliers etc. and verify expenses booked for such ancillary services.

14.5 Underreporting of income, income offered after netting off, chargeable income shown as advance, diversion of income to near relatives are certain common modes of tax evasion. Splitting of income to divert chargeable income to other year had also been noticed. It is therefore, necessary to verify the disclosed income with reference to the income reported in 26AS. Reference should be made to concerns/ agencies, who hired the professional to gather information of income and should be compared with ITR.

14.6 The matter of TDS on income from engineering professional service is another highly debatable issue. Whether tax is deductible *u/s* 194C or 194J or 194H has always been a matter of great controversy. The AOs are required to examine all facts related to the case very carefully for drawing a correct and logical conclusion.

15. GENERAL METHODS OF EVASION, AND INVESTIGATION

15.1 The prevalent methods of tax evasion in these cases are also basically the same, i.e. either suppression of receipts, or inflation of expenses or both. Suppression of receipts is generally resorted to where the fees/ payments received are either in cash or received out of unaccounted sources of the payer. This is an easier method of evasion in these cases. The need for inflating expenses arises only when the accounted receipts become very large in comparison to the income intended to be offered for taxation.

15.2 Some points should be noted at the outset, *viz*.:

a. Fees received from unaccounted sources of the payer are normally not meant to be disclosed by the professionals.

b. Professionals like lawyers/ advocates, often do not account for the out-of-pocket expenses, or the remuneration for an out-of-court settlement etc.., received in high profile/ sensitive cases.

c. When the fees/ remunerations is received in cash, the normal tendency is not to account it in the books.

d. Where receipts are not subject to proper checks or verification, the only way out is to proceed for verification of personal expenses & investments.

15.3 Verification of Bank Accounts: This is the best method of initiating an investigation in such cases. The trend of today's financial world is that most of transactions, including fraudulent ones are routed through banks in some form or the other. All large transactions have to go through banking channel at some point of time. A thorough examination of the debits and credits of the bank account had yielded good results in a large number of cases. The points relating to investigation of bank accounts have been discussed at length in Volume-1, which needs to be kept in mind by the AO**.**

15.4 Statement of Total Wealth: Another important tool of investigation in these cases is calling of statements of total wealth at the beginning & end of the investigation period, using the power available *u/s* 142(1) of the Act.

15.5 Inquiries from Passport/ Travel Agents: Verification of particulars of passport can bring out the details of foreign travel. Thereafter, verification from travel agents can be made to find out expenses on air tickets,

foreign exchange, hotels bookings etc.. Similarly travel agencies patronised by these person can be a source of information for their domestic travel, holidays, hotel bookings, and expenses on hospitality etc. Verification, from luxury hotels, caterers, event managers etc. can bring out information on expenses incurred on major parties, functions & events etc.

15.6 Surveys *u/s* 133A: Lastly, surveys, particularly in the case of architects, interior designers, fashion designers, industrial consultants and valuers etc.., can yield extremely useful information relating to suppression of income. Surveys sometime become inevitable due to the fact that accounts of professional are generally not properly maintained. For instance, appointment diary of lawyer/ advocates; list of projects undertaken by architects, interior designers; the estimates of cost of construction/ renovation of a project; the noting of actual expenses etc., if found can be of immense use during the course of investigation. Action *u/s* 133A(5) at the end of an event like musical concert, stage show, exhibition etc. can be a useful tool to detect unaccounted income.

15.7 Inquiries from Investment Agents/ Advisers: Most of these people entrust their investment work either to a trusted confidante or to a professional investment consultant/ adviser. Particulars of such person generally become known, as they are paid fees for their services. Enquiries or even a survey in the case of these persons can often bring out a wealth of information regarding the actual investments of the professional concerned.

CHAPTER

17

Hospitality Industry

1. INTRODUCTION

1.1 The direct contribution of tourism and hospitality industry to GDP is expected to register a Compound Annual Growth Rate (CAGR) of roughly 14%. The launch of several marketing initiatives by the Government of India, such as Incredible India! & Atithi Devo Bhava, has provided an impetus to the growth of this industry. Now-a-days, the market players of the industry are providing services in an integrated manner on a single portal for ensuring better services to the customers. For example, makemytrip.com, cleartrip.com and a host of other websites provide a comprehensive basket of facilities, which include outbound and inbound travel for leisure and business trips, hotels, transportation, holiday packages etc., both for the domestic and international circuit.

1.2 The Indian Government has also initiated a fresh category of visa—the medical visa or M-visa, to encourage medical tourism in India. Indian medical tourism is expected to reach USD 8 billion by 2020. The growth of travel and tourism industry in India has paved the way for the growth of Hospitality Industry. The Indian hospitality sector is highly fragmented with a large number of small and unorganized players. However, competition is increasing day by day due to the entry of new and bigger players.

1.3 In general, the hotel business can be categorized into the following:

a. Guest Houses with or without restaurants.

b. Budget Hotels/ Boutique Hotels with no star status.

c. Three or four star hotels in big towns.

d. Five star hotels or seven star hotels in Metropolitan cities or at places of tourist attractions.

e. Clubs and Resorts in the luxury sector.

1.4 Broadly, the functioning of a hotel is divided into Front Office and a Back Office. Then, there are various sections, such as-Reception, Room Service, Housekeeping, Laundry, Travel desk, Health club, Gym, Bars, Pubs, Coffee shop, Florist, Telephone, Kitchen, Business Centre, Conference halls, Banquet hall, etc. Each of the sections have a well-defined function and maintains a separate account for each guest of the hotel along-with a folder in which all the

duly signed vouchers of the guests signatures are kept. This basic record is Utilised for settling the account of the guests, at the time of check out. A final bill is raised by the Account's department based on these supporting vouchers sent by the various sections. Thus, at the time of vacating a room, the settlement of the account of the guest is done by way of a consolidated bill, which may be cleared by the customer through cash, cheque, credit card, debit card, bank transfer, RTGS etc.

1.5 Apart from the front office, back office and administrative Section every hotel has two critical sections namely, the Accommodation Section & Service Section.

2. ACCOMMODATION SECTION

2.1 The accommodation is provided normally by the reception counter of the hotel. There are various types of guests in a hotel, such as, guests who have made the bookings through the websites like Booking.com, Goibibo, Agoda, expedia etc., company guests, regular guests, frequents travelers, walk-in guests, booked guests, privileged guests, etc.

2.2 Usually, there is an immediate allotment of room to the guests, who have already booked the accommodation at an agreed room rent. The hotel reception can also offer discount to walk-in guests, in case the hotel rooms are not fully occupied. Normally, the front manager is allowed to give discount from 20% to 30% for which negotiations are carried out with the customers. In most of the hotels, the booking rates, agreed upon with a particular customer is duly entered and maintained on a computer.

2.3 Guest's Registration Forms: As a standard practice, all hotels require the guests to fill information in a registration form and the hotel guest register. The information required in this form is in the nature of name, profession, address, place of origin, arrival from, departure to, arrival date and time, and expected departure date and time, room number, mode of payment and signature. The Guests are required to give their photo identity card and a copy of the same is retained by the Hotel. In respect of foreign travelers, the information in the registration form also includes details regarding their nationality, passport number (date of issue, place of issue, validity, Visa Number, and its validity period etc.). The information regarding a foreign traveler/ guest is sent to the Police Commissioner's office on the next working day, against an acknowledgment. A copy of this acknowledgment is kept with hotel.

2.4 The registration forms of guests maintained by the hotel, is a starting point for any worthwhile investigation on the occupancy and the room rents offered to the guests. The AO's can cross check these with the registers maintained by room service, restaurants, house-keeping and laundry etc. If a particular expenditure is mentioned in relation to a particular room in the room service register, but if the occupancy register does not have any information about that person then an obvious inference can be drawn that the records are not properly maintained and the case needs further investigation. As soon as a guest arrives and checks into the room, a key card is normally given for identification of the guest in the hotel and, for utilization of the services of the hotel.

2.5 The information regarding the guests has to be invariably sent to the house-keeping and the room service sections from the reception counter. The house keeping Section keeps the records of duration of occupancy of the guest and the needs of the guest. The room service keeps the records of various orders placed from the room along-with the time. Similar records are kept by the laundry, restaurant, telephone, health club, gym, bar and pub etc. A floor-wise register is usually maintained by the house keeping Section to indicate the number of rooms occupied and the number of rooms lying vacant. Every floor has house keepers, who besides maintaining the rooms, has to maintain this register.

2.6 Room Charges: The charges of a room fixed by a hotel are normally based on size of the room; the amenities provided (fruit basket, welcome drink, soap, shower, caps, tooth brush, tooth paste, shampoo, toilet rolls etc.); the facilities provided in the room (TV, telephone, wifi-facility, size of the bed, sitting area etc.); other conveniences provided by the hotel to its guests such as free use of business centre, swimming pool, health club etc.; tariffs of other hotels of same category; overheads; Star rating and exclusive nature of the facilities.

2.7 Closure Report: The reports of the night auditors submitted every day are very important for the purposes of investigation of the accounts of a hotel. These night auditors cross check the accounts with respect to the services rendered by each department to a guest or a visitor to a restaurant, a party or a function organized in the hotel. They have to ensure that all the services have been appropriately charged and in case of mistakes, they direct the correction of the same. One set of the report of the night auditors remains with the Accounts Section in the back office, and another set is sent to the front office.

3. SERVICE SECTION

3.1 This Section includes maintenance and upkeep of hotel building, machinery, equipment, garden, electricity, kitchen, catering, appliances, rooms etc.

3.2 Stores: Stores in a hotel are handled by a store keeper or a Material Manager. The Materials Manager has to ensure that all the necessary items are available at all points of time for the smooth running of the hotel. For maintenance of the desired level of stock, the manager has to do various calculations with regard to each items based on the consumption of a particular item. As soon as the stock of any item comes down, the material manager and the store keeper take steps to replenish the same. Different hotels may follow different practices for purchase of consumable stores. For this they may conduct market survey or call tenders from the suppliers on annual rate basis. Once the rates are finalized for the entire year, the supplier has to supply the item throughout the year at the agreed rates irrespective of the market rates of the items at any particular point of time in the year. With the advent of online grocery stores, the optimum level of raw material is being maintained, leading to reduced inventory cost and improved margin of profit.

3.3 The AO's should analyze the utilization of stock and the purchase *vis-à-vis* the sales turnover of food and beverages, sale of rooms etc.

4. RECORDS MAINTAINED

The books of accounts & records maintained by a hotel depend upon nature of its ownership, size of its activities, nature of services offered. The basic records maintained by the hotels, in computerized or manual format, generally are:

a. Cash Book
b. General ledger
c. Guest Register with guest registration forms
d. Occupancy register maintained by some of the hotels.
e. Debtors ledger
f. Stock register
g. Suppliers ledger
h. Fixed assets ledger
i. Salary register
j. Guest complaint register
k. Attendance Rolls of Employees
l. Excise register

5. SOME COMMON METHODS OF TAX EVASION

5.1 The actual data relating to store consumption is manipulated to match with the

stock as per books of account. The records of the stores are generally, so manipulated that no evidence is left with regard to actual purchase and the consumption of the stores. However, if the supplier's records and the books of accounts of the assessee are cross checked & verified, the actual purchases of stores made by a hotel can be traced. By working out the average consumption over different periods, the actual stock consumption can be worked out.

5.2 Room occupancy is often understated in the books of account and shown at lower levels, even if the actual occupancy is quite high. It may be mentioned that even if the room occupancy register is manipulated, it is possible to cross-check the actual occupancy levels, with the help of the registers maintained in the different sections of the hotel, such as room service register, housekeeping register, restaurant register, wi-fi charges, health club, gym register etc., as it is impossible for an assessee to doctor the entire actual record. If this cross checking is done methodically, it may be possible to work out the occupancy of the rooms. In fact, the guest registration register cannot be easily manipulated and should be invariably verified by the AO Further, the GST returns may also be verified to reconcile with the sale of rooms by the assessee.

5.3 Many tourists who are on short visits are availing bed and breakfast services only. This is generally a package deal. At times the guests do not avail the package deal and the hotels, while charging the other customers for breakfast do not account for the same as their sales as they are showing them as complimentary and setting off the unavailed facility against other regular customers.

5.4 The Assessing Officers may also verify the sales made through the online agents like GoIbibo, Booking.com, Agoda, OYO rooms etc. and crosscheck the sales of the online agents with the books of accounts of the hotel to detect possible suppression.

5.5 As soon as a guest arrives in a hotel and is booked into the guest arrival register by the Receptionist, the Receptionist informs the checking in of the guest to the various departments of the hotel, namely, housekeeping, room service, telephone operator, engineering department and the finance department. All these departments open a separate ledger account for the particular guest in which the transactions relating to that guest are entered. These departments send a note to the finance department for billing at the time of checking out. When a guest checks in, he may be asked to deposit a particular amount depending upon the duration of his stay and probable expenditure in the hotel. In case the guest over stays or his expenditure is more than the deposit amount, the finance department/ reception takes a further deposit from the guest to cover the extra expenses.

5.6 Thus, the finance department is kept abreast of the expenses incurred by a particular guest in a hotel. Even if the records of the finance department are subsequently altered, the position of occupancy as per the ledger accounts and bills maintained by the various departments, should be examined to find out the correct information. As per the international norms, the receipts of a hotel is generally 80% from the room tariff and the balance 20% is on account of sale of food and other services utilised by the guests of the hotel.

5.7 Electricity and water bills may be examined to check inflation of expenses on these counts.

5.8 Manipulation in Receipts Pertaining to the Banquet Halls: Understatement of catering receipts from parties etc. by understating the number of people or the charges per persons or both, is quite common. Normally, in large hotels the information of any party to be held and the number of people likely to attend such a party is immediately sent along with the approved menu to the kitchen, stores, engineering department, reception, bell desk as also to vigilance and

security, general manager, executive manager and housekeeping. The trail as to the actual number of people who attended the party may be left in several of these departments, and the registers maintained by them. If the store registers for the given day are properly checked with respect to the quantity issued, the number of person attending the party on that day can be inferred. The manager has to give a Kitchen Order Ticket (KOT) for the exact number of people so that the kitchen would prepare the food for that many people. Two copies of this KOT go to the kitchen, another copy goes to the cashier or the finance department, and fourth copy remains in the books. In some outlets, the KOT has three copies, two of which will go to the kitchen and third will remain in the book. This KOT has to be maintained till the night auditor checks the accounts. This position is not only applicable for big parties, but also to the hotel guests or restaurants etc. The checking of the KOT in the kitchen and from the cashier can lead to clues with regard to the number of people who attended a particular party or with regard to the occupancy of the hotel at a particular point of time or also with regard to the actual receipts in a restaurant of the hotel. KOT is a good tool in the hands of a diligent investigator.

5.9 In corporate hotels, this manipulation has a different dimension. In such hotels, the bill of a party of say 1000 persons is broken into various separate segments. Either it will be shown in the form of breakfast, lunch and dinner and thus a single party of 1000 persons would be broken into three segments in different names or it will be shown as if three parties were held in the same hall by three different persons. One of the names would be of the person who has actually held the party and the other two names would be dummy.

5.10 If the hotel having flight kitchen is catering to airline operator, the books of accounts may be cross verified with the books of the airline operator. The Assessing Officer may verify the agreements entered by Hotels with the Airline operators in this regard and also examine the expenses relating to Flight Kitchen services.

5.11 The assessee incurs sizeable expenditure on renovation and repair and maintenance and claim this as revenue expenditure. The Assessing officers may verify the nature of the expenditure and capitalize the same wherever necessary.

6. CASE STUDY ON BANQUET HALLS

6.1 In most parts of Southern India, a number of marriage halls have come up which are used for weddings as also other social functions. These halls are known as 'Marriage Halls'. Many of these Marriage Halls are constructed by charitable trusts claiming it as a charitable activity. The hire charges received are sometimes disguised as donations or even donations towards corpus. This tactic is employed to circumvent the provisions of Section 11 or to avoid the requirements regarding application or accumulation of funds. In fact, many of these Marriage Halls are pure and simple business propositions with the main object of earning business profits. The hire charge is given by the user of the premises for the function. A donation is a voluntary payment given without any anticipation of return of any kind. Thus, such compulsory payments towards hire charges involving quid-pro-quo are not donations. The Hon'ble Supreme Court had in the case of *CET vs. P.V.G. Raju* [1975] 101 ITR 465 (SC) had defined 'donation' as an act by which the owner of a thing voluntarily transfers the title and possession of the same from himself to another, without any consideration. Therefore, the AO can examine and find evidence to prove that the alleged donations were actually rent or hire charges paid for the marriage functions. However, the onus of establishing that there was a 'quid-pro-quo' is on the AO. As far as the running of Marriage Halls is concerned it is a systematic activity for the purpose of profit earning and, therefore, the income earned is a business income, which can be fortified with the decision of the Supreme Court in *Municipal Corporation of Delhi vs. Children Book Trust*

[1992] 3 SCC 390; AIR 1902 SC 1456. In this case, the Hon'ble Supreme Court had dealt with the scope and effect of the term "charitable purpose" and as to what exactly was charity. Whether this income is 'incidental' to the avowed charitable objects of the Trust may have to be examined and a discussion reported on pages 47 to 49 of 236 ITR is of relevance.

6.2 Another variation of these alleged donations is that while the donation is given in a particular name, however, the marriage function is organized in the name of another person. Thus, it would appear that there is no nexus between the donation and the marriage function. These tactics are applied to avoid scrutiny vis-a-vis the provisions of Section 11 of the Income-tax Act. However, these marriage halls are booked sometimes 6 to 8 months in advance. At the time of booking an advance is given by the original person, who is actually organizing the function. In the entry for the advance it is clearly noted that certain amount has been received from Mr. X for the purposes of a marriage on a particular date. However, subsequently, the donation is given in another name and the advance is refunded to the original person. By seeing the advance register and by proving that the marriage or other function was actually solemnized by the original person on that particular date in the hall, the management can be questioned as to why no payment has been taken from the original person for the said unction. If properly investigated, the falsity of the claim of donation by can be found out and the amount can be brought to tax.

6.3 The above stipulation apart, some of these Marriage Halls are constructed by individuals for business purposes. Some of these halls are very lavishly constructed and charge heavily for the use of the hall for each day. This activity involves the following services provided either directly or through contractors:

a. Running & maintenance of these halls on daily basis.
b. Providing of decoration services.
c. Taking various permissions from Police, Municipality or other departments for organizing of a particular function.
d. Contract for music and sound appliances provided to the hirers.
e. Provision of food to the guests.
f. Providing chairs, sofas, tables and other seating arrangements.
g. Providing the services of daily wage workers.
h. Provision of marriage band or an orchestra.
i. Charging of rent for the hall and for any or all of the above services from the hirer.
j. Disposal & Cleaning of the various types of leftovers.
k. Providing telephone or fax services in the hall.
l. Providing generators.
m. Providing gas burners, utensils and crockery.
n. Providing video coverage.
o. Providing for flower arrangement.

6.4 In such an organized activity, an AO will have to examine as to whether proper accounts have been maintained. If it is a case simply of giving on hire the hall without attending to any of the services mentioned above, then it is a simple issue and the AO should tax the hire charges as business income. However, in case the assessee is managing the hall and is providing or organizing any of the above attendant services, relating to the function, then, the matter is slightly complicated, wherein the AO has to work out the income earned from each of these activities for the purpose of taxation. It may also have to be examined by the AO, as to what is the profit element in providing the attendant services. It also may have to be seen as to whether proper

TDS has been made from the payments made to various contractors.

6.5 Most of these Marriage Halls and the management of the community halls make it obligatory for the hirer to take the services for furniture, decoration, sound system, flowers for decoration, video coverage, food service etc. only from the management of the hall. In such cases, the entire receipts may have to be reflected in the accounts maintained by the management of the hall and the AO is required to examine the same.

6.6 Once the function is over all the paraphernalia is immediately removed within no time. The management may choose to show the hiring and occupancy as per its own sweet will and books of accounts can be suitably written. Therefore, the AO would have to see as to what the type of management is and what financial control is being exercised by the management on the hiring activities. Records relating to the permissions obtained from the authorities for holding functions in the hall can provide information regarding the functions & the dates on which these were organized. If the telephone and fax facilities are provided in the hall, the bills of those particular dates can provide clues about the functions organized on those dates.

6.7 Apart from suppressing the occupancy rate the management can also inflate the expenditure on running and maintenance of the hall. The number of workers actually employed on a regular basis needs to be ascertained by the AO by making relevant enquiries. Sometimes, some of the management have many halls in different parts of the cities, where the same workers are deployed for the running and maintenance of the halls. However, in the books of account, for each hall separate workers are shown to be employed for the purpose of running and maintenance.

6.8 These halls have regular contractors, for providing various services. A cross-check with the books of accounts of these contractors can also give clues regarding the occupancy of the halls, as also the income earned by the management of the halls.

7. CASE STUDIES ON STAND-ALONE RESTAURANTS

7.1 Many stand-alone restaurants suppress their profit either by suppression of income or inflation of purchases or manipulating the bills by removing some food and beverages items from original bill or recording huge discount in the system against bills fully paid by the customer.

7.2 In a case of Search on a chain of restaurants, owning/ controlling more than 40 restaurants in Delhi, NCR, Mumbai, Pune; call interception and CDR tower ID provided lead on key employees and the modus operandi. It was found that the assessee was using customised software 'CSAT' meant for hotel business and dedicated software expert was employed for manipulation of sales data. The hard disks from computers were periodically removed to avoid forensic data recovery. However, hard discs/ pen drive containing all accounting data were recovered from the residence of key employees and all accounting data was found in pen drives. The analysis of the data revealed large scale sales suppression by:

a. Recording huge discount in the system against bills fully paid by customers.

b. Removing some food and beverages items from the original bill.

Therefore, during investigation the Assessing Officer should also carefully examine the software used by the restaurant owner and understand the possible manipulation of accounts.

7.3 In another case it was found that the assessee was using accounting server and sales server separately to compute the sales of 8 branches of their restaurants. It was found during the search that the assessee was systematically accounting the sales of only 7 branches and suppressing the

sales of one branch instead of suppressing the sales at the point of sales. Hence, the Assessing Officer should compare the sales of all branches with the books of accounts in cases there are several branches of the restaurant.

7.4 In the case of a restaurant and sweets seller, it was found during the survey that the assessee was having several branches in the city and was also opening special counters on festive occasions but the receipts from all the branches were being systematically manipulated to maintain the desired level of sales only. The modus operandi adopted was that the assessee would feed the data from all the branches at the end of the day in the computer and was using custom made software to wipe clean the location of the file on the hard disc having the sales data and copy the manipulated data in the hard disc. Normally a deleted file can be retrieved from the hard disc but the assessee was going a step further to manipulate the contents of the location on the hard disc where the sales figures were stored and it was difficult to retrieve the actual data. After several months, another survey was carried out at the time of closure of business at the end of the day and the survey team could catch hold of the actual sales figures for the day. Therefore, in cases of restaurants, the Assessing Officer should carefully plan their time of investigation towards the closure of business so that the actual sale figures of the day could be obtained ruling out any possibility of manipulation.

7.5 Many restaurants these days use cash registers for generating the bills. The Assessing Officers should be conversant with the operation of these machines as after the bills are raised, many bills are kept by the cashier and receipts are manipulated at the end of the day/ month. These registers have sufficient memory to record the sales of several days. While investigating such cases, the cash register should be examined to verify probable manipulation of sales.

7.6 Since hospitality industry is making an extensive use of technology for all its activities, the Assessing Officers also need to keep themselves updated with these technologies for carrying out effective investigation.

CHAPTER 18

Travel and Tour Industry

1. INTRODUCTION

1.1 Tourism has emerged as one of the fastest growing industry in the world. However, India's share in terms of world tourist arrivals and receipts is negligible, hovering around 0.5% of the world-wide market. The Foreign Exchange earnings from tourism in INR terms is Rs. 1,54,146 Crore.

1.2 Tourism has great potential in India. International institutions like the World Tourism Organisation and World Travel and Tourism Council have all predicted that India is going to be an important destination in the 21st century. India has a blend of rich cultural and scenic locations in the right proportion, offering a tourist options from snow capped peaks to beautiful beaches, the choicest hill stations, pilgrimage sites, health resorts, back waters etc.. If our infrastructure facilities could keep pace with the growth in the tourism industry the tourism revenues can develop by leaps and bounds. The World Travel and Tourism Council estimates that the Tourism in India accounts for 9.6% of GDP and is the 3rd largest foreign exchange earner for the country. According to World Tourist Organisation, the foreign tourist arrival in India is expected to reach 15.3 million by 2025. The Government of India has set a target of 20 million Foreign Tourist Arrivals by 2020 and double the Forex earnings. The role of the travel agent, therefore, assumes significance.

1.3 Before any country, can attract tourists on a large scale, certain important facilities and services must exist to cater to the needs of tourists from the time of arrival to their departure. The businesses and organisations, which provide the facilities and services, make up the tourism industry.

1.4 Using the words 'origin' and 'destination', are two main ways to describe the movement of tourists from one place to another. 'Inbound' and 'outbound' tourists are terms commonly used in the tourism industry. Inbound tourists are tourists entering a country from their country of origin and outbound tourists are those who leave their country of origin to travel to another country. The words 'in-bound' and out-bound only apply on the outward journey at the beginning of the tourist place. On the return trip, the tourist is simply returning home. Domestic tourist is the term used to describe tourist trips which takes place by tourists in their own country, i.e., when the country of origin and the country of destination are same.

2. THE RETAIL TRAVEL TRADE

2.1 The most visible element of retail travel trade is the travel agency. This is the place, where the customer's first visit to buy travel tickets, book hotels, hire vehicles, buy holiday packages etc. In general, travel agencies earn commission income for arranging and organizing these services. In this regard, the latest development is the arrival of various online players like *makemytrip.com*, *booking.com*, *cleartrip.com*, *Goibibo*, etc. The travel agents, therefore, operate and provide services nowadays both offline and online.

2.2 Travel agents undertake a specific function in the tourism industry. They make travel arrangements on behalf of individuals or group. They act as intermediaries between the customers and organisations that provide travel products and services. Travel agencies are the retail arm of the travel and tourism industry. The fact that opening a travel agency does not involve a heavy initial capital outlay attracts many people to this trade.

2.3 Travel agencies act on behalf of two parties when they undertake their work. They are agents for the customers on whose behalf they are making the travel arrangements, and also for the company that is supplying the product i.e. the Principal. Travel agents earn commission from the Principals, whose products they sell. The commission payment is usually expressed as a percentage and varies according to the product being sold and the commission policy of the Principal. The percentage of commission offered by the principal fluctuates, as per the prevailing market condition. Some principals, also offer incentive commission, wherein the amount of commission increases as the sales turnover increases. Overriding commission is paid when an office has sole agency status with a particular Principal. The overriding commission allows the sole agency to pay standard commission to the agents and retain a small override to cover its costs.

2.4 By checking the declaration of revenues of online travel platforms like *makemytrip.com*, *booking.com*, *cleartrip.com*, *Goibibo*, etc., the tax authorities can detect evasion of tax revenues by the clients. The data collected from the online platforms in some cases had also revealed concealment of income by various hotels and other service providers. Needless to mention here that there is a profit sharing agreement between the online platforms and the service providers like hotels, transportation, air tickets etc., which needs to be investigated and enquired in appropriate cases. Thus, the data available with the online platforms is very valuable from the point of view of a tax investigator.

2.5 The Directorate General of Central Excise Intelligence (DGCEI) has investigated a large number of online travel companies for service tax evasion. It had been found that these companies don't deposit service tax which they collect from the customers. Thus, the information obtained from the GST Department is of prime importance to check whether the online companies are declaring their correct turnover or not in their returns of income.

2.6 A typical travel agency, offers a wide range of products and services, which may include:

a. Overseas and Domestic package tours.
b. Air tickets, both domestic and international
c. Rail tickets.
d. Car hire.
e. Coach services.
f. Cruise trips.
g. Hotel and other accommodations
h. Arranging Guides for tourists
i. Travel Insurance.
j. Foreign currency and traveler's cheques
k. Visa & Passport applications.

All these items earn the travel agent commission income, which keeps the business running. In the case of airline, coach or rail tickets sold by a travel agency, the carrier pays the commission to the travel agent. But a high proportion of income of travel agents comes through selling holidays packages.

2.7 Impact of Information Technology: There has been a complete change in the travel agency business due to impact of information technology and the internet. The travel agents are moving from being mere ticket-issuers to travel consultants providing end to end solutions to the customers' needs. Today, the distribution structure of the airline ticketing has changed with about 75% being distributed through electronic channels, airline portals and electronic travel agents like clear trip, makemytrip, goibibo etc. and the remaining 25% is through the travel agents. Further, almost all airlines have already begun e-ticketing or paperless tickets on the web. The concept of the travel agent is also changing from just an agent charging commission to a consultant charging management fee.

3. TICKETING BUSINESS

There are a large number of travel agents who are engaged in the ticketing of domestic and international airlines. The travel agents can be broadly classified under the following heads:

a. Agents accredited with IATA.
b. Non-IATA Agents
c. General Sales Agents

4. IATA AGENTS

4.1 Almost all the important air carriers are members of International Air Transport Association (IATA), which is an international agency under the U.N. charter. All the approved air carriers are bound by resolutions of IATA. The accreditation by IATA is granted after a thorough scrutiny of the agent's financial status.

4.2 The airlines have been steadily bringing down the commission of the agents, since past several years. However, many airlines have introduced productivity linked incentives of about 2% to be given to the agents over and above the fixed commission. The IATA resolutions provide for special commission in respect of a tour operator, who is in charge of or escorts a minimum of 10 passengers. In case of a group size of 15 or more passengers, one free tour operator's ticket is issued for every 15 passengers. If the group comprises of 10 to 14 passengers, 50% of the applicable normal/ special fair as paid by the group is applicable for the tour conductor. The travel agency makes the payment of tickets to the airline after deducting their commission and this practice is as per the procedure laid down by the IATA, which provides for submitting the statement of tickets issued on a fortnightly basis. The IATA agents also receive other incentives which may extend up to 25% of the fare. Besides the commission and incentives, they are eligible for productivity linked benefits linked with the targets given by various airlines, depending on the volume of the business done for the airlines.

4.3 Billing & Settlement Plan: Commonly known as BSP, this is a simple form which provides for the selling, reporting and making remittances by the IATA agents. The key feature of the BSP is a single standard traffic document, which is used by IATA agents on behalf of all the participating airlines. Earlier, they were required to prepare and keep separate stock and accounts for different airlines. BSP uses the services of the Data Processing Centres to compute billing and monetary amounts, which agents are required to remit to the appointed clearing banks. It also computes the division of the amounts collected by the banks for settlement amongst the airlines. The Centre conducts the editing and checking of data from all documents and generates one consolidated billing to each agent in respect of all the moneys owed to the BSP airlines. The agent then makes a single remittance to the appointed clearing bank.

4.4 Accounting Procedures: The airlines provide the agents with the net fare chargeable for all tickets issued. The tickets are then recorded in the purchase register and payments are made to the IATA BSP on a fortnightly basis. These amounts are debited to the cost of sales in INR through the purchase register. The net fare charged by the airlines is decided at the beginning, right at the time of the issuance of the ticket. The incentives are also generally fixed in the beginning of the year. During lean seasons, the airlines announce concessional fares, which are the net fare payable to the airlines. As the tickets show the full fare, the difference between the prices for which the ticket is sold and the net fare paid to the airlines is the profit margin of the agent. As already stated, the payments are settled on a fortnightly basis through BSP. For the tickets issued for the first fortnight, the payments are made on the 30th of the month and for the tickets issued in the second fortnight payments are made on the 15th of the following month based on the fortnightly sales report prepared by the agent for all the tickets issued in the fortnight.

5. NON-IATA AGENTS

These are the subagents, who are not accredited by IATA. They do booking on behalf of various IATA agents, who pass on to them, a part of the commission received by them from the airlines. These sub-agents also part with a small part of their commission to the walk-in customers, who purchase tickets from them. The extent of commission passed on to the customers depends upon the competition and negotiating ability of the customers. Non-IATA agents do not have stock of the air tickets.

6. GENERAL SALES AGENTS

The General Sales Agents are appointed by the scheduled airlines to sell the tickets of that particular airline in a particular territory. They cannot sell the tickets of any other airline, other than the airline for which they are authorised. They normally do not operate at a place, where that airline has its own office. The General Sales Agent is entitled to an overriding commission of 3% on all the sales made in his region.

7. TAX EVASION & INVESTIGATIONS

7.1 The walk-in customers, generally purchase tickets and tour packages in cash. The commission passed on to them is deducted in the bill itself. The customers, therefore, are paying the net amount to the agent i.e., gross value of the air ticket minus commission passed on to them. Investigations in some cases indicate that the agents do not have any evidence in the form of vouchers/ receipts containing the signatures of the customers. The evidence of passing of commission to the customers available with the assessee is the bills given to the customers. These bills also do not contain the signature of the customer. In the absence of such evidence, the quantum of commission actually passed on to the customers cannot be properly ascertained. It is possible that the assessee after having given a bill to such a customer can increase the quantum of commission passed on to the customers in the copy of the bill which remains with the assessee and which forms a part of the books of account. The quantum of commission claimed to have been passed on to the walk-in customers is often as high as 30% to 40% and needs to be thoroughly investigated, particularly in cases, where the commission has been passed on in the form of cash. In the case of search and survey operations, the Tax Officials should get themselves fully acquainted with the tailor-made software used by the agents for the accounting purposes. No meaningful investigation can be carried out without understanding the nature of accounting entries entered in the software package. Further, the various consolidated reports generated from the software installed are of extreme importance for getting a bird's eye-view of the entire business operation of the agent.

7.2 It is well known that the airlines provide several incentives to the agents in the form of free tickets and other freebies, which may not

be disclosed by the agent. It is also possible that additional incentives and productivity linked benefits are not fully disclosed by the agents. It would, therefore, be worthwhile to collect information from the airlines directly about the commission and incentives paid to the travel agents. The airlines should be asked to provide circulars by which special fares or various commission/ discount/ incentives were announced. Thus, as a first step towards investigation, the Tax Officials should collect all the agreements, circulars, correspondence, letters etc. in relation to the commission receivable and then examine the same with reference to entries of commission credited in the books of account. Similarly, information may be collected from sub-agents about the actual commission paid to them. Inquiries in some of the cases revealed that there is a difference between the amount of commission shown by sub-agents and that debited in the books of account of the agents. The natural corollary is that either agents are passing less commission to the sub-agents compared to that shown in their books of account or sub-agents are showing less commission than what they have actually received.

8. PACKAGED HOLIDAYS & TOUR OPERATORS

8.1 Package holidays, also known as package tours, include transport to the destination; food and accommodation at the destination; services of a guide or tour-representative accompanying the travelers to guide and advice on excursions or sight-seeing tours. Most holidays advertised in holiday brochures contain these elements in one package. The people who put together the above-mentioned facilities are called tour operators.

8.2 Unlike the travel agents who sell the holidays and other travel products, tour operators actually develop and customize holiday plans putting together different packages tailored to suit the needs of an individual or group of travelers. They book hotel space, airline seats and other services in bulk and then repackage them into the holidays that are offered for sale through travel agents. Most of overseas 'inclusive tours' have three separate elements *viz.* Accommodation, Transportation and Other services. The accommodation component of the package is provided in association with hotels, motels, resorts, clubs etc. The transport element of a package holiday can be travelled by air, coach, rail or ship. Whichever mode of transport is used, the tour operators are offered preferential discounted rates known as inclusive tour rates. Apart from accommodation and transport, a package holiday may usually also include other services such as transfers, the services of a representative, car hire, excursions, equipment hire etc.

9. TOUR OPERATORS

9.1 The tour operators can be divided into following four categories:

a. Mass market operators.

b. Specialist operators.

c. Domestic operators.

d. Incoming tour operators.

9.2 Mass market operators include some of the well-known names in the industry such as Thomas Cook, Cox & Kings etc. These companies cover a major share of the package holiday market. The specialist operators offer holidays and other travel arrangements to a particular geographical region or destination. Domestic operators specialize in marketing of domestic tours only. Inbound tour operators cater to the needs of overseas visitors, who choose to visit India.

10. DISCOUNTING

10.1 Tour operators obtain different elements of their inclusive tours at discounted rates from suppliers such as hoteliers and airlines who are happy to negotiate a discount in return for releasing an agreed amount of stock. Discounting is also prevalent at the other end of the distribution chain namely discounted holidays offered for sale by a travel agency.

10.2 The travel agent/ tour operator has to be in touch with the following types of leisure facility operators and also get commission from them:

a. Establishments offering accommodation-for example, hotels, guest houses etc.

b. Catering & hospitality facilities-cafes, restaurant, fast food outlets, bars and pubs etc.

c. Arts and entertainment venues-art galleries, theaters, casinos etc.

d. Sport & recreation facilities-parks, golf courses, outdoor stadiums.

e. Heritage & Cultural facilities-including museums, historic places, gardens etc.

10.3 Now-a-days some of the travel agents/ tour operators are tying up with the budget hotels on an exclusive basis. It is learnt that travel agents and tour operators are assuring the hotels of a steady business for a commission ranging from 25% to 35%. The tie up is on exclusive basis i.e. no business will be given to any other hotel except the one with whom they had tied up or in some cases two agencies enter into alliance with each other assuring to give business on exchange of good commission.

10.4 The tour operators organize various services, which are narrated as below:

a. Firstly, visas are arranged for allowing the customer to enter their respective destinations abroad. Apart from the visa fees paid to the embassies or consulates, fees are charged for the services rendered.

b. The stay arrangements for customers include services such as hotel accommodation, meals, breakfast and transfers. These services are provided, as per the brochures published.

c. The POE (Protector of Emigration services) clearance is arranged for those persons for whom emigration check is required. A hefty service charge is collected by the agents from the customers for ECR (Emmigration Check Required).

d. Medi-claim policy is obtained when the passenger travels to European countries and the United States. This insurance protects the customers and all his medical expenses are taken care of. The premium amount is paid to the insurance company, and in turn this is charged from the customers.

11. BOOKING PROCEDURES: OUTBOUND TOURS

11.1 The customers are booked at the branches by paying a certain amount of deposit depending upon the tour which they want to undertake. The bookings are also received through travel agents on behalf of the customers. The branch accountant maintains client-wise accounts to keep track of his deposits and the expenses incurred. The branch office advises the bookings made for the day to the tour operation unit in the head office. The tour operation unit takes the booking on record specifying the tour and date etc. and it advises the land operator abroad for providing necessary services in the respective countries. The head office maintains the books of accounts such as cash book, ledger, purchase and sale registers etc.. The payments are received at the branch office for which payment & receipt scrolls are prepared and forwarded to the head office.

11.2 The branch office receives payment in INR and USD. The INR is spent towards meeting expenses of visa, Mediclaim and ticketing and the USD is spent towards land arrangements. The sales register is normally maintained for all the payments received from the customers and details are reflected such as invoice number and date, customer's name, tour and the amount. The sundry creditors register is maintained for all Purchases done from airlines and the land operators. Some of the tour operators do not show receipts of amounts collected in forex on the plea that the passenger makes his payment in rupees in India and US dollars abroad from

his entitlement to the foreign tour operator for meeting the land arrangements, meals, hotel accommodation etc.

11.3 The foreign exchange is received from the customers from their BTQ (Basic Travel Quota) entitlement. It is collected as per the tour; the customer is joining. If it is accounted in the books, the agent/ operator debits the amount payable by the customer and credit is given to the various turnover accounts.

11.4 In case of fly-now-pay-later schemes, the customer's credibility is got assessed by some finance company. The finance company makes down payment after deducting their charges (10–15%) which is included in the package and makes the net payment to the travel agent depending upon each tour. The customer makes the equated payment to the finance company.

12. INBOUND TOURS

12.1 Normally, under the agreement between a foreign travel agent and the Indian inbound tour operators, the Indian tour operator has to provide the following services:

a. Arranging for and supplying tariff details to cover the handling of tourists, including hotel accommodation, boarding, air transportation between India and overseas, local transportation, sight-seeing arrangements etc.

b. Making all arrangements in India for visits of tourists to different places of interest including airport transfers, hotel accommodation, boarding, ground, air and water transportation, providing qualified English or other language guides, entertainment and such other facilities to make the visit of the tourist comfortable.

c. Obtaining licenses or permits required to enable the tourists to complete their tour itineraries.

d. Arranging in India for ticket bookings and reservations subject to the terms and conditions as may be prescribed by the parties for whom such ticket bookings and reservations are made.

12.2 The Indian company sends itemized invoices for each group giving the actual cost for all services, after adding a mark-up. It may also decide to charge a lump sum amount depending upon the settlement with the overseas agent.

13. ACCOUNTING FOR INBOUND TOURS

13.1 The procedure adopted by the inbound tour operators, in general, is as follows:

a. For every tour, a separate ledger account is opened.

b. The bill raised on the overseas tour operator is credited to this account.

c. All costs incurred for that tour, like air tickets, hotel bills, transporters bills guide charges etc.. are debited to this account.

d. The difference between the bills raised and cost incurred is transferred to the inbound tours commission account.

e. For all tours completed on or before 31st March, the tour commission is accounted for in that financial year itself.

f. If for any tour completed before 31st March, some bills for cost are not received till 31st March, then provision for that amount is kept in that tour account and commission is accounted for accordingly. In the next year, expenses pertaining to that tour get adjusted towards the provisions.

13.2 Tour Commission: For every tour, a bill is raised on an overseas tour operator. Expenses on tours like hotel, transport, air tickets, escort and guide charges are paid by the Indian agent. The difference between amount billed to the overseas operator for a particular tour and the expenses incurred for that tour is booked as tour commission.

13.3 Books of Account Maintained: Normally following types of books are maintained:

a. Domestic travel register
b. International travel register
c. Passport and visa register
d. Hotel register
e. Tour register (inbound and outbound)
f. Bill register
g. Rail register etc.
h. The ledgers are general ledger, debit and credit, travel, tour, hotel, airlines ledgers etc.

14. INVESTIGATION OF ACCOUNTS OF TRAVEL AGENTS/ TOUR OPERATORS

14.1 The basic issue, which arise in investigating the accounts of travel agents and tour operators relate to ascertaining the correct amount of commission/ discount received by them and commission/ discount actually passed on to the sub agents or customers. The travel agents get a good deal of commission in selling the packaged tours and the tour operators obtain heavy discount from hotels, airlines and other facility providers. Even for arranging shopping from select shops and emporiums, for which the agent/ operator gets a certain amount of commission. Though it is difficult to ascertain the exact amount of commission, discounts or incentive passed on in this trade, an attempt can be made by comparing these figures in the books of the entity paying commission and that receiving it. A wide variation has been observed in cases, where such relevant and appropriate enquiries have been conducted. Further, most of the travel agents are booking tickets in the name of Walk in customers wherein they do not maintain proper details like address, contact numbers etc and most of these transactions are done through cash. Therefore, care must be taken during assessments on the details of walk in customers where in a travel agent has a chance to manipulate the commission passed to them. The AOs should look in to these cash transactions in greater details.

14.2 The commission payable to sub agents is debited in the profit and loss account but actually it is not paid. While, the travel agent debits this amount as an expense, the sub agents do not show such receipts on the ground that they are maintaining accounts on cash basis.

14.3 Some tickets are given free by the airlines which can be sold in the open market at the prevailing rates. Some are given at discount for the employees, which also can be en-cashed in open market. It may be verified whether these are properly accounted for in the books of accounts. There are occasions when airlines have given luxury cars like Mercedes Benz to the agents for achieving certain targets. Such, expenses are debited under the sales promotion account of the airlines. The AO may see as to what treatment has been given by the agent to such gifts.

14.4 Further, on cancelled tickets, agents mostly don't pass the amount returned by the airlines to the walk-in customers and they account this as payable to customers. The issue of cancelled tickets and the refund of the ticket amount should be enquired by the AOs, during the assessment proceedings.

14.5 If there are no connecting flights, as also in some other special circumstances, free stay in hotels is provided by the air carrier. These facilities are sometimes charged by the travel agent.

14.6 Some of the agents, in their books of accounts show income from ticketing only. Miscellaneous income earned by way of passport and visa services, cancellation etc. are

not shown. This may be proper investigated by the AO.

14.7 In case of unskilled workers who go abroad in groups, the amount towards the ticketing and POE charges is received in cash. Substantial discounts may be shown in such cases, though in reality, it may not have been passed on. The amount of discount given to the customers in such cases may be carefully examined.

14.8 A glance at the profit and loss account of major travel agents may reveal that they have credited only net commission to the P/L account. If a part of the commission is given to a client out of the commission received from the airlines, the same is netted off from the commission account itself. The travel agent reduces his income with that amount instead of showing it as an expense. Similarly, for inbound tours, he essentially books hotels, arrange transfers etc. on behalf of the overseas tour operators and earns commission in the process. Here also, only the net figure is credited to the P&L a/c after deducting expenses incurred on providing services for each tour. In view of this the AO may have to call for the books of accounts and examine the ledger account of each tour to see what type of expenses have been debited and what discounts have been received. Thus, the AO should invariably examine the nature of entries, representing the difference between the Gross commission and Net commission.

14.9 A large amount of commission/ handling charges is sometimes paid to intermediaries which are sister concerns of the agent. The genuineness of services rendered by such concerns, as also the reasonableness of such payments should be examined by the AO.

14.10 As mentioned earlier, the foreign exchange component collected from the customers in respect of outbound tours is not reflected by the tour operators on the ground that payment is made abroad for land arrangements. The receipts in forex charged by the tour operator and the amount spent should be examined by the AO and if there remains any surplus, the same should be taxed.

15. DEDUCTION *U/S* 80HHD OF THE INCOME-TAX ACT, 1961

15.1 Both the travel agent and approved tour operators are eligible for deduction under the provisions of this section. The term 'Travel Agent' has been defined in Clause (a) of the Explanation at the end of the Section to mean a travel agent or other person (not being an airline or a shipping company) who holds a valid license granted by the Reserve Bank of India *u/s* 32 of Foreign Exchange Management Act, 1999. Similarly, the tour operator has to be approved by the Prescribed Authority, who is the Director General of Tourism. Unless these conditions are satisfied, no deduction is available to the travel agent or the tour operator.

15.2 The Section 80HHD provides for deduction in respect of earnings in convertible foreign exchange. Clause (c) of the Explanation clarifies that services provided to foreign tourist shall not include services by way of sale in any shop owned and managed by a hotel, tour operator or travel agent. However, services provided at health clubs, beauty parlors, barber shops etc. owned or managed by a hotel, tour operator or travel agent will be included in the term 'services provided to the foreign tourist' and will be entitled to deduction under this Section. But if such health club, beauty parlors etc. also sells some goods to foreign tourists, such sale cannot be included in the term 'services' provided to the foreign tourist.

15.3 The deduction is not restricted to the first recipient of the convertible foreign exchange. In some cases, the foreign tourist visits India on a package tour and makes payment in foreign

exchange in one lump sum to a tour operator in India and the Indian tour operator, thereafter, makes payments to the hotels, where the tourist groups are lodged. The Section has been amended [Explanation 1 below sub-section (2) of Section 80HHD] to provide that in cases where payments for services to the foreign tourist provided by hotel, tour operator or a travel agent are received in Indian currency from another tour operator or travel agent or airline, the person providing services to the foreign tourist will be eligible for the deduction u/s 80HHD in relation to profits derived there-from, subject to the condition that the payment in Indian currency is made out of funds obtained by conversion of foreign exchange brought into India, through an authorized dealer in foreign exchange, by the tour operator, travel agent, or the airline on behalf of the foreign tourist. The person claiming the deduction is required to furnish along with the return of income a certificate obtained from the person making payment in Indian currency out of foreign exchange paid by the foreigner.

CHAPTER 19

Charitable Trusts and Institutions

1. INTRODUCTION

Various provisions regarding Trusts, Societies, Institutions etc. claiming exemption are administered mainly by Chief Commissioner of Income-tax (Exemptions) and the Commissioners of Income-tax functioning under him in fourteen cities, namely, Ahemdabad, Bangalore, Bhopal, Chandigarh, Chennai, Delhi, Hyderabad, Jaipur, Kochi, Kolkata, Lucknow, Mumbai, Patna and Pune. As per notification no.52/ 2014/ F.No.18738/ 2014(ITA.I) dated 22 October, 2014, issued by CBDT, the jurisdiction of CsIT(Exemptions) is as follows:

"All cases of persons in the territorial area specified in column (4) claiming exemption under Clauses (21), (22), (22A), (22B), (23), (23A), (23AAA), (23B), (23C), (23F), (23FA), (24,) (46) and (47) of Section 10, Section 11, Section 12, Section 13A and Section 13B of the Income-tax Act, 1961".

2. CONDITIONS FOR CLAIMING EXEMPTIONS

Any trust or institution carrying out activities for charitable purposes may claim exemption under Section 11 and 12 or under Section 10(23C) of the Income-tax Act, 1961. The trust or institution, to claim exemption under these sections; need to satisfy the following conditions:

a. It should be a public trust or society or a company registered under Section 8 of the Companies Act; and

b. It should carry out charitable purpose.

c. It should be registered with the Income-tax Department. The authority competent to grant registration *u/s* 12AA (for claiming exemption *u/s* 11 and 12) and 10(23C)(iv), (v), (vi) and (via) is the CIT(Exemptions).

d. It should fulfil the conditions laid down under Section 11, 12 and 13 or 10(23C) as the case may be.

3. CHARITABLE PURPOSE

3.1 As per Section 2(15) of Income-tax Act, 1961, "charitable purpose" includes:

a. Relief of the poor

b. education

c. yoga

d. medical relief

e. preservation of environment (including watersheds, forests and wildlife)

f. preservation of monuments or places or objects of artistic or historic interest, and

g. the advancement of any other object of general public utility:

3.2 Whether Charitable? Proviso to Section 2(15)

3.2.1 Proviso to Section 2(15) provides that the advancement of any other object of general public utility shall not be a charitable purpose, if:

a. it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business,

b. such activity is for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity,

Unless

(i) such activity is undertaken in the course of actual carrying out of such advancement of any other object of general public utility; and

(ii) the aggregate receipts from such activity or activities during the previous year, do not exceed twenty per cent of the total receipts, of the trust or institution undertaking such activity or activities, of that previous year;

Proviso to Section 2(15) is also applicable in the cases of trust or institution registered *u/s* 10(23C) (iv), (v), (vi) and (via) as per 19th proviso to Section 10(23C).

3.2.2 Points of Investigation:

a. The Assessing Officer should examine whether the assessee is carrying out any activity in the nature of any other object of general public utility. The AO should carefully examine the objects of the Trust and actual charitable activities being undertaken. Whether the activities are in the nature of first six limbs of Section 2(15) may be examined by information available in the public domain, physical verifications, verifications from third parties such as the District Authorities where charitable activities were carried out or different government agencies for whom projects were carried out by the assessee.

b. The CIT (Exemption) while issuing the certificate of registration specifically mentions the category of charitable activities for which registration is granted. The AO should carefully go through the registration documents to examine whether the assessee has adhered to the nature of activities as per registration document granted by the CIT (Exemptions).

c. The amount of receipts from such activities and whether the receipts exceed 20% of the total receipt.

4. CONDITIONS FOR EXEMPTION AS PER SECTION 11, 12, 13 AND 10(23C)

4.1 Verification of Registration

4.1.1 The first condition for claiming exemption *u/s* 11&12 or 10(23C)(iv), (v), (vi) and (via) is that the assesee shall have the requisite approval from the appropriate Income-tax Authority.

4.1.2 Points of Investigation

a. The Assessing Officer should examine whether a valid approval under Section 11&12 or 10(23C)(iv), (v), (vi) and (via) is available with the assessee.

b. The Assessing Officer should examine whether the approval is valid as on date. There is a possibility that the approval

has been withdrawn by the appropriate authority on a later date after the grant of the approval. The updated list of such registrations/ withdrawals are available on the website of the Income-tax Department at the following link:

https://www.incometaxindia.gov.in/Pages/utilities/exempted-institutions.aspx

The details of the registered institutions can also be verified from the registers maintained in the office of the CIT(E).

c. The Assessing Officer should examine whether the conditions prescribed by the authority granting approval have been fulfilled by the assesee. Generally, the following conditions are prescribed by the CIT(E) while granting the registration:

(i) Assessee shall maintain its accounts regularly and also get them audited to comply with Sec. 80G(5)(iv) read with Section 12A(1)(b) and 12A(1)(c) and submit the same before the assessing officer by the due date as per Section 139(1) of the Income-tax Act, 1961.

(ii) Every receipt issued to donor shall bear the number and date of this order and shall state the date up to which this certificate is valid.

(iii) No change in the deed of the trust/ association shall be effected without the due procedure of Law and its intimation shall be given immediately to this office.

(iv) The approval to the institution/ fund shall apply to the donations received only if fund/ institution, established in India for charitable purpose, fulfils the conditions as laid down in Section 80G5(i), (ii), (iii), (iv), (v) & (5B) of the Income-tax Act, 1961.

(v) This office and the assessing officer shall also be informed about the managing trustee of the assessee Trust/ Society/ Non-profit company and the places where the activities of the Trust/ Institution are undertaken/ likely to be undertaken to satisfy the claimed objects.

(vi) Assessee shall file the return of income of its fund/ institution as per Section 139(1)/ (4A)/ (4C) of the Income-tax Act, 1961.

(vii) No cases or fee or any other consideration shall be received in violation of Section 2(15) of the Income-tax Act, 1961.

(viii) No deduction shall be allowed u/s 80G in respect of donation of any sum exceeding Res. 2000/- unless such sum is paid by any mode other than cash, in view of Section 80G(5D) of the Act. Any receipt issued in this regard should clearly mention that donation exceeding Rs. 2000/- in cash shall not be eligible for deduction u/s 80G of the Act.

d. The Assessing Officer should examine whether the registration/ approval is valid for the assessment year under consideration. The registration certificate issued by appropriate authority is valid w.e.f. assessment year mentioned in the certificate.

4.2 Meaning of Income

4.2.1 As per Section 2(24) (iia) of the Act, income of the trust/ institution includes voluntary contributions. Income, however, does not include corpus donation (Section 11(1)(d)) and specified grants in view of decisions of Hon'ble High Courts that have been accepted by the Department (Gujarat High Court in Gujarat State Council for blood transfusion and Punjab and Harayana High Court in Punjab State e-Governance Society). Income generated out of the charitable activities will also be part of income of the trust/ institution that needs to be applied as per the provisions of the Act for

charitable purposes such as school fees, hospital receipts etc.

4.2.2 Points of Investigation

a. The Assessing Officer should examine whether any income has been directly credited to the Balance Sheet in Reserve and Surplus. Some examples may be development fees, membership fees etc. directly taken to Balance Sheet.

b. The Assessing Officer should examine whether income arising out of investments has been directly taken to the Balance Sheet and added to the investment. Such income also needs to be applied for charitable purposes.

c. The Assessing Officer should examine whether any income has been reported to the Income-tax Department by any reporting entity that has not been disclosed by the assessee in its computation of income. Such information can be accessed through Individual Transaction Statement (ITS) in ITBA/ ITD system.

d. The AO should examine whether all the assets of trust/ institutions are being used for charitable purposes specially immovable properties. A list of immovable property should be called for and physical verification in sample cases may be carried out to find out instances of misuse of the assets of the trust. There may be instances where the trust properties are occupied by the trustees or their relatives for their personal use or running their businesses etc. At times such properties may not be visible from Balance Sheet since they may have been received as donation in kind and may not have been recorded in the books of account.

e. The AO should examine whether the resources of trust/ institution have been used for the personal benefits of trustees or other specified persons. There may be instances where the employees of trust are used for the personal benefits of trustees. Recording of statements of such persons may reveal their actual usage.

4.3 Application of Income

4.3.1 The trust or institution needs to apply at least 85% of the income during the year for charitable purposes. The application comprises both the revenue as well as capital expenses incurred for charitable purposes.

4.3.2 Points of Investigation

a. The Assessing Officer should examine whether any fees concession has been shown both in income and application side of the Income & Expenditure account. It will result in allowance of extra 15% application on such concession since such concession does not form part of the income.

b. The Assessing Officer should examine whether any capital asset was acquired out of borrowed funds and the cost of acquisition as well as the repayment of loan has been claimed as application. Both the claims may also be made by the assesee in different years. This will result in double deduction of the same application. The AO should examine the financials and computation of income of relevant year in which the asset was acquired, in case if repayment of loan is claimed during the year, to verify whether it is a case of double deduction.

c. The Assessing Officer should examine whether the claim of application on account of different expenses is genuine and is supported by appropriate documentary evidences. Here the focus of the AO need to be on identification of cases of diversion of funds through bogus or inflated expenses. It need to be check whether money has been taken away from trust by booking such bogus expenses by any of specified persons, in which case,

entire exemption may be denied as per the provisions of Section 13(1)(c). However, for denial of exemption, the enquires should be carried out to establish linkage of siphoning of funds from trusts to benefit of specified persons. The data available from open source on the relationship between the parties in whose name expenses have been booked by the trusts and specified persons may be helpful. For example in some cases the company to whom bogus payments have been made is owned by one of specified persons.

d. In certain cases, the person from whom goods/ services have been claimed to be purchased/ procured may not exist at all. In some such cases, the case of such persons might have been selected in NMS (Non Filler Monitoring System) and the notice served on such person might have returned back. The AO may write to the AO of such person for getting information on existence of such parties. The names of such persons may also be searched in the list of entry operators circulated by Department from time to time.

e. Bank statements of third parties to whom payments have been claimed to be made by the assessee may also be examined to verify the flow of funds.

f. In suitable cases, the AO can also get physical verification done to examine the existence of assessee, genuineness of activities carried out and to gather information about any non charitable activity carried out by the assessee.

g. The Assessing Officer should examine whether the application claimed is towards an object specifically stated in the deed of registration else such activities would be beyond the scope of the trust/ institution and would not be allowable.

h. If the assessee has given donations to other trusts/ institutions and claimed as application, the AO should verify whether the donee trust is also registered as chartable institution with Income-tax Department and the donation is not in the nature of corpus donation.

4.4 Donations

4.4.1 As per the provisions of Section 12, any voluntary contribution received by the trust or institution shall be deemed to be income of the trust or institutions.

4.4.2 Points of Investigation

a. The Assessing Officer should examine whether all voluntary contributions have been shown as income by the assesee. Donation register/ receipt register may be examined in this regard. Examination of bank statements may also reveal some receipts which have not been accounted for by the assessee.

b. A report by banks of charitable institutions is also filed with FIU. In appropriate cases request may be made to FIU regarding the bank accounts maintained by the assessee which may reveal some undisclosed accounts.

c. As per the provisions of Section 80G(5D), no deduction *u/s* 80G will be allowed on cash donations exceeding Rs. 2000/-. Receipts registers/ 80G certificates may be examined alongwith bank statement to find out instances of violation of Section 80G(5D).

d. The Assessing Officer should examine whether the receipts declared as voluntary contributions are in the nature of donations or receipts for carrying out some work or rendering services. In case if the receipts are for rendering services, applicability

of provisions of Section 11(4), 11(4A) and proviso to Section 2(15) need to be examined. In case if TDS has been deducted on such transactions under Section 194C/ 194J, the same would be reflected in Form 26AS which is available to AO as a part of ITS (Individual Transaction Statement).

e. Copy of grant letters and agreements may also be examined to ascertain true nature of receipt.

f. The Assessing Officer should examine whether the records with respect to identity of the donors are maintained by the assesee. In case if such records are not maintained, donation may be treated as anonymous donation as per the provisions of Section 115BBC in case of non-religious charitable institutions. In some cases, donation may not actually have been given by such person. AO may verify such cases on sample basis by sending notices to the donors.

g. In case of suspicious foreign donations, a request may be made to FT&TR Division of CBDT to get information from respective countries about genuineness of donations.

4.5 Corpus Donations

4.5.1 Corpus donations are to be excluded entirely from the assessable income of the trust or institution under Section 11(1)(d). In other words, voluntary contributions received with a specific direction from the donor that they shall form part of the corpus will get excluded from the taxable income of the trust or institution under Section 11(1)(d). However, there is no such provision for charitable institution claiming exemption *u/s* 10(23C). Further, as per the provisions of explanation 2 to Section 11 (w.e.f. A.Y. 2018–19), any corpus donation by a charitable institution to another shall not qualify as applications for the donor charitable institution.

4.5.2 Points of Investigation

The Assessing Officer should examine whether the receipts claimed to be corpus donation by the assesee qualify the following conditions:

a. The receipt is in the nature of donation

b. The donation is made voluntarily

c. The donor gives a specific direction that the donation is for the corpus.

If the assessee has received fees from the applicant members/ students, it will not been in the nature of donation since donation is made without any expectation of return. Secondly the term voluntary clearly indicate the discretion of the donor both in term of making the donation and the quantum of donation. In case, if the person giving money to the trust or institution does not have discretion in terms of amount to be paid then this cannot be regarded as corpus donation. For example in case of member ship fees etc., there is no discretion regarding the amount to be paid. Further, there has to be a specific direction of donation towards corpus which can arise only when the donor has an option to choose.

a. The Assessing Officer should examine whether corpus donation has been received from another organisation on or after A.Y. 18–19. In such cases as per explanation 2 to Section 11, such donor will not be eligible to claim such donation as application.

b. The Assessing Officer should examine whether the corpus donations claimed by the assesee are genuine. In case if the source of the donations is not found to the genuine, provisions of Section 68 read with Section 115BBE may be examined.

c. The Assessing Officer should examine whether the receipts claimed to be corpus donation by the assesee are meant for permanent fund. Corpus donation means

voluntary contribution towards permanent fund which had been given with specific direction and, therefore, it cannot be used in any manner contrary to the direction of the donor. Normally, diversion of the corpus fund for any purpose, whether loans and advances, is a clear violation of the specific direction of the donor and also against the spirit of the applicable laws of the land. A corpus is a permanent capital which normally cannot be used either as application or any loan & advance to any other trust or party.

d. The Assessing Officer should examine whether any income on corpus fund has also been treated as corpus donation. The income of corpus fund has to be treated as income and 85% thereof need to be applied.

e. In certain cases, corpus donations may be used as means of tax evasion since the donor gets tax deductions *u/s* 80G and the donee's income is also exempt. In cases where AO has reasons to doubt, detailed investigation may be carried out into the bank statements of both donor and donee to find out instances of cash withdrawal if any, the communication between donor and donee should also be examined to verify the intention of donor, instances of donations by the same donor to other donees during the same period may also be helpful in ascertaining the genuineness of transactions.

4.6 Accumulation of Surplus

4.6.1 Under Section 11(1)(a), in addition to the income actually applied to charitable/ religious purposes, income of the trust/ institution to the extent of 15 per cent of the income derived during the year, if accumulated or set apart for future application to such purposes, is also eligible for exemption. No procedural requirements have been laid down for such accumulation of upto 15 per cent of the income derived during the year.

4.6.2 Apart from accumulation of 15 per cent of income permitted under Section 11(1)(a), a trust or institution is permitted under Section 11(2) to accumulate or set apart income for specific purpose(s). Such accumulation or setting apart of income has to be for definite and concrete purposes and should not be vague. Section 11(2) has been amended w.e.f. A.Y. 2016–17 which specifically provided that statement for accumulation in Form-10 shall be filed by the assesee before the due date of filing return of Income. Rule-17(2) has also been amended w.e.f. A.Y. 2016–17 specifically providing that Form-10 shall be submitted on or before due date of filing return of Income as per the procedure laid down by DGIT(Systems). As per the procedure laid down by DGIT(Systems), Form-10 needs to be filed on e-filing portal. Stated briefly, the amount sought to be accumulated under Section 11(2) shall be excluded from taxable income provided the following conditions are satisfied:

i. Form-10 need to be filed on e-filing portal by the assesee, and

ii. The money so accumulated or set apart is invested in the forms or modes mentioned in Section 11(5).

4.6.3 As per Rule 17, the notice has to be given on or before the due date of filing the return under Section 139(1). However, subject to certain conditions, the Board has authorized the Commissioner or Director to extend the aforesaid time limit if good and sufficient reason is shown for the inability to give the notice in time. The Circular stipulates satisfaction of five conditions before the time limit is extended. These are as under:

a. The genuineness of the trust is not in doubt;

b. The failure to give notice to the Assessing Officer and invest the surplus in time was only due to over-sight;

c. The trustees or settler have not benefited by such failure directly or indirectly;

d. The trust agrees to invest the surplus before the extension of time is granted;

e. The accumulation was necessary for carrying out the object of the trust.

4.6.4 Income accumulated or set apart under Section 11(2) for attainment of specific purposes has to be used for the specified purposes within the specified period. An infringement of the conditions of accumulation can occur on any or all of the following grounds:

a. It is applied to purposes other than charitable or religious purposes,

b. It ceases to remain invested in the manner specified under Section 11(5),

c. It is not applied for the purposes for which it was accumulated, or

d. It is credited or paid to any other charitable or religious trust or institution or other such institution mentioned under Section 11(3)(d).

4.6.5 Upon the occurrence of any of the aforesaid events, the amount will be taken as the income of the previous year in which such event takes place. It may happen that an assessee is unable to apply accumulated income for the purposes for which it was accumulated because of reasons beyond his control. In such a situation, Section 11(3A) allows the assessee to make an application to the assessing officer requesting for change of purpose(s) for application of income.

4.6.6 Trust or institution is also allowed to accumulate the surplus for 1 year as per the provisions of explanation 1(2) to Section 11(1). However, the assesee needs to submit Form-9A in such case as per Rule-17(3) before due date of furnishing return of income.

4.6.7 Points of Investigation

a. The Assessing Officer should examine whether the assesee has claimed 15% application with respect to any specified grant in computation of income while the income has been claimed to be exempt. In such cases, since specified grant has been claimed to be not forming part of income, hence 15% accumulation thereof shall not be allowed. For example:

Income	200
Specified grant	100
Total	300
Less 15% accumulation allowed *u/s* 11(1)(a)	45
Balance	255
Specified grants not part of income	100
Balance income to be applied	155
Actual application	155

Thus, it can be seen from the above example that required application of income should have been 85% of Rs. 200 i.e. Rs. 170. But, the assesse is claiming 15% of specified grant amounting to Rs. 100 as well which is resulting in reduction of required application from 170 to 155. This is not allowable.

a. The Assessing Officer should examine whether Form-10 has been filed online. The Forms filed online are available on e-filing portal. The access of e-filing portal is available to all the AOs As per the provisions of Section 13(9), in case of non filing of Form 10 online as per the procedure laid down in the section, accumulation will not be allowed.

b. The Assessing Officer should examine whether Schedule-I of ITR has been duly filled in by the assessee. It contains the details of present as well as past accumulations.

c. The Assessing Officer should examine whether the accumulations during previous year have been applied during the year. The application out of previous years' accumulations during the year is required to be separately reported in Schedule-ER and Schedule-EC of ITR-7.

4.7 Application Outside India

4.7.1 Section 11(1)(c) permits deduction of expenditure incurred outside India provided that such application of income promotes international welfare in which India is interested. However, for deduction of such expenditure, prior approval of the Board is required.

4.7.2 Points of Investigation

a. The Assessing Officer should examine whether a valid approval from CBDT for application outside India is available with the assesee and whether the same is applicable for the year under consideration or not, which are based on the following considerations:

   (i) Whether the trust or institution is allowed to carry out activities outside India as per the deed of registration.

   (ii) Whether the activities carried out outside India are in the nature of charitable activities as defined in Section 2(15).

   (iii) Whether the activities carried out side India tend to promote International Welfare in which India is interested.

b. The AO should verify the transactions relating to foreign remittance reported in Form 15CA which are made available to the AO in ITS.

4.8 Transfer of Capital Asset

4.8.1 Section 11(1A) of the Act deals with capital gains arising or accruing to a charitable trust or institution. The position of law is that in the case of a charitable trust or institution eligible for exemption under Section 11, capital gains, whether long term or short term, will be deemed to have been applied to charitable purposes and will be exempt from tax to the extent they are reinvested in a new capital asset. The provision applies with necessary modifications to cases where the capital asset is held only partly (and not wholly) for religious or charitable purpose.

4.8.2 In case the sale consideration of capital asset is not applied for charitable purposes, the sale consideration needs to be treated as income. The following table will make the legal position quite clear:

Particulars	Business assessee		assessee registered *u/s* 12AA	
	amount	Deduction allowed	Amount	Deduction allowed
Cost of acquisition	100	Nil	100	100
Depreciation	40	40	40	Nil
WDV	60		60	
Sale consideration	45		45	(-)45
Loss	15	15	15	Nil
Cost of the use of asset	55	55	55	55

4.8.3 As seen from the above example, if the asset of Rs 100 is acquired by the assesse and sold for Rs 45, the assessee has effectively spent Rs 55 and, therefore, only Rs 55 shall be allowed as application. In the case of a normal business assesse, the assesse is not allowed the deduction for the cost of the asset and is rather allowed depreciation of Rs 40 and Rs 15 as loss on the same of asset. But in case of a trust, since the expense of Rs 100 has already been allowed as expense, at the time of the sale of asset, the amount of Rs 45, being the sale consideration is to be taxed.

4.8.4 Points of Investigation

a. The Assessing Officer should examine whether the assessee has claimed depreciation or cost of asset as application of income.

b. The Assessing Officer should examine whether the assessee has invested in new capital asset as per the provision of Section 11(1A). In case if assessee fails to invest in new asset as per the provision of Section

11(1A), the sale consideration of the asset transfer shall be treated as income.

4.9 Business Undertaking held by Assessee

4.9.1 At times, a business undertaking may be settled into trust or institution. In such a case, if the income of such business undertaking is Utilised for charitable purposes for which trust or institution is registered then the income from such business undertaking will not be liable to tax. The AO shall have the power to determine the income of such undertaking in accordance with the provisions of Income-tax Act relating to assessment and where the income so determined is in excess of income as shown in the account of undertaking then such excess shall be chargeable to tax.

4.9.2 Points of Investigation

a. The Assessing Officer should examine whether the business undertaking is settled as property held under trust.

b. The Assessing Officer should examine whether the income of business undertaking has been applied for charitable purposes. The income of business undertaking needs to be applied for charitable purposes during the year as per the provisions of Section 11(1)(a) of Income-tax Act.

4.10 Incidental Business

4.10.1 Section 11(4A) deals with income of a trust or institution by way of a business which is incidental to attainment of its objects. The income of such a business will be entitled to exemption under Section11 if separate books of account are maintained, otherwise, the income will not be entitled to benefit of exemption under Sections 11 and 12.

4.10.2 "Incidental" means, offshoot of the main activities; inherent by-product of principal activities. Activities to compliment and support the main objectives are not in the nature of incidental to the business. The genesis of incidental activities must be from the principal activities themselves. There cannot be one source for the principal activities and another source for incidental activities.

4.10.3 Points of Investigation

a. The Assessing Officer should examine whether any TDS *u/s* 194C/ 194J of Income-tax Act, 1961 has been deducted in the case of the assesee. This information is available to the AO as per ITS statement. TDS *u/s* 194C is deducted for carrying out contractual work and *u/s* 194J is deducted for rendering professional services. If the assessee has disclosed certain receipts on which TDS under any of these two sections has been deducted then it needs to be verified whether these receipts are from any business activity or not and secondly whether such business activity is incidental to main activities of the trust or not.

b. The Assessing Officer should examine whether separate books of accounts are maintained by the assessee for trade or business activities claimed to be incidental as required by Section 11(4A).

c. The Assessing Officer should examine whether the business activities carried out by the assessee are necessary for carrying out the main activities and are emanating from the main activities.

4.11 Permitted Modes of Investment

4.11.1 The Charitable trust/ institutions are allowed to invest only in prescribed modes of investment. As per Section 13(1)(d), if a trust or institutions invests in any mode except these prescribed modes then the exemption *u/s* 11 and 12 shall be denied as per the provision of Section 13(1)(d). Similar provision is also contained in 3rd proviso to Section 10(23C).

4.11.2 Points of Investigation

a. The Assessing Officer should examine whether the trust or institution has invested its surplus only in prescribed modes of investment or there is any investment beyond these modes.

b. The Assessing Officer should examine whether trust or institutions has any investment in shares of a company which is not allowed as per Section 11(5).

c. The instances of violation of Section 11(5) and 13(1)(d) should be reported to the CIT in view of Section 12AA(4).

4.12 Treatment of Depreciation

4.12.1 As per the provisions of Section 11(6), depreciation is not allowed as application of income if the cost of assets has been claimed by the assessee as application. The assessee has an option to claim either the cost of asset as application or to claim depreciation thereon as application. This provision has come into effect w.e.f. A.Y. 2015–16. Upto A.Y. 2014–15, Hon'ble Supreme Court in the case of Commissioner of Income-tax-III, Pune v. Rajasthan & Gujarati Charitable Foundation Poona [2018] 89 taxmann.com 127 (SC)/ [2018] 253 Taxmann 165 (SC)/[2018] 402 ITR 441 (SC)/ [2018] 300 CTR 1 (SC) has decided that both depreciations as well as cost of asset has to be allowed to the assessee.

4.12.2 Points of Investigation

a. The Assessing Officer should examine whether the assessee has claimed depreciation on assets or not. With effect from A.Y. 2015–16, in case if assessee claims depreciation, it needs to be verified whether cost of asset has also been claimed by the assessee as application of income.

b. The Assessing Officer should examine whether the assessee has taken loan against capital assets and claiming repayment of loan as application of income since it will result in double claim of same application.

c. The Assessing Officer should examine whether the sale consideration of an asset on which depreciation was claimed by the assessee has been treated in terms of provisions of Section 11(1A).

4.13 Modification of Objects

4.13.1 As per the provisions of Section 12A(ab), w.e.f. A.Y. 2018–19, if an assesee subsequent to its registration *u/s* 12AA, adopts or undertakes modifications of objects which do not confirm to the conditions of registration then such trust or institutions shall apply for registration *u/s* 12AA again within 30 days from the date of such modification/ adoption.

4.13.2 Points of Investigation and Techniques

a. The Assessing Officer should examine whether any modification has taken place in the objects of the trust or institutions registered with the Income-tax Department.

b. In case if any modification has taken place, whether application as per the provision of Section 12A(1)(ab) has been filed by the assesee.

c. The Assessing Officer should examine whether the trust or institution has received registration *u/s* 12AA for the modified objects.

4.14 Audit Report

4.14.1 As per the provisions of Section 12A(b), every trust or institution is required to get its accounts audited and submit audit report in Form-10B if its total income without giving effect to provisions of Section 11 and 12 exceeds maximum amount which is not chargeable to tax. Similar provision is also contained in 10th proviso to Section 10(23C). The relevant from in such cases is Form-10BB. Circular: No. 143 [F. No. 180/ 74/ 73-IT(A-I)], dated 20-8-1974 needs to be referred in this regard.

4.14.2 Points of Investigation

The Assessing Officer should examine whether audit report in Form-10B has been submitted by the assessee in case the assessee is registered in Section 12AA of Income-tax Act.

4.15 Filing of Return of Income

4.15.1 A charitable or religious trust or institution is mandatorily required to file a return of income under Section 139(4A) if its income without giving effect to the provisions of Sections 11 and 12 exceeds the maximum amount not chargeable to Income-tax. In other words, such a trust or institution must file a return of income if it has taxable income for the year before claiming exemption under Sections 11 and 12. The report of the auditor in Form 10B has to be filed along with the return.

4.15.2 Points of Investigation

a. The Assessing Officer should examine whether the assessee has filed return of income by due date. In case if assessee has not filed return of income by due date, w.e.f. A.Y. 2018–19 exemptions shall be denied to the trust or institution registered *u/s* 12AA.

b. As per the provisions of Section 139(4A) and (4C), return of income is required to be submitted if income derived from property exceeds the maximum amount which is not chargeable to tax without giving effect to provisions of Section 11 and 12.

4.16 Benefit not for Public

4.16.1 If income of the trust or institution is applied for the benefit of private purposes which is not for public benefit then exemption *u/s* 11 and 12 shall not be available. Courts have held that a Section of public shall also be considered to be public.

4.16.2 Points of Investigation

a. The Assessing Officer should examine whether the beneficiaries are public at large or certain private individuals. In case if benefit is given by the trust or institution to certain individuals who are related to each other by birth or caste or religion then exemption *u/s* 11 and 12 shall not be available.

b. The Assessing Officer should examine whether the trust or institution has been created to give benefit to any particular religious community or caste. Religious trust is allowed to be registered as per Section 11 and 12 but the benefits passed on by such trust shall not be restricted to a particular religious community or caste.

4.17 Benefits to Specified Person

4.17.1 Section 13(1)(c) provides that if the trust or institution has directly or indirectly benefited any specified person, as referred to in Section 13(3), then exemption *u/s* 11 and 12 shall not be allowed to the assessee. Section 13(3) defines such persons which includes trustees, their relatives and their related concerns etc. The idea is that the management of the trust or institutions shall not derive any benefit either directly or indirectly. For example, if a contract for constructing school building of the school run by the assessee has been given to company owned and managed by the trustee at a price higher than market price, then a benefit has been passed on by the trust or institution to specified person. Since the legislation has provided extra ordinary benefits to the trust or institutions in the form of complete tax exemption, hence a responsibility has also been imposed on them to maintain absolute fairness so that public money is not misused. Therefore, in case of violations of Section 13(1)(c), entire exemption *u/s* 11 and 12 is to be denied.

4.17.2 Section 13(2) provides instances where a benefits directly or indirectly has been passed on to specified persons as defined in Section 13(3). These instances includes use of trust properties by specified persons without adequate consideration, payment of unreasonable salary or allowances, purchase of sale of property without adequate consideration, diversion of income or property etc.

4.17.3 Points of Investigation

a. The Assessing Officer should examine whether transaction with specified person

has been reported by the auditor in Form-10B/ 10BB. In case of such reported transaction, the reasonableness of the consideration needs to be verified.

b. The Assessing Officer should examine whether all the transaction with specified persons have been reported by the auditor. In some cases, advances or security deposits are given by trust or institution to the specified persons which are not reported in Form-10B or 10BB. A careful scrutiny of Balance Sheet and Income & Expenditure account may reveal such transactions.

c. The Assessing Officer should examine whether trust or institution has entered into transaction with the entities in which trustees, authors etc. have substantial interest. At times list of such entities may not be readily available with the AO Publically available information on the website of Ministry of Corporate Affairs etc. may help the AO in tracing such entities.

d. The violations of this Section should be reported to the CIT as per the provisions of Section 12AA(4).

4.18 Anonymous Donation

4.18.1 A significant legal change has been brought about by Finance Act, 2006 with effect from 01.04.2007 by inserting a new provision (Section 115BBC) whereby anonymous donations will not enjoy exemption but would be chargeable to tax at the rate of 30 per cent from Assessment Year 2007–08 onwards. This provision, as it stands after further amendment by Finance Act, 2009, lays down that from Assessment Year 2010–11 onwards, tax treatment of anonymous donations (i.e. donations in respect of which the assessee fund/ trust/ institution etc. does not maintain records of identity indicating the name and address, or other particulars of the donor as are prescribed under the I-T Act) would be as follows:

a. Anonymous donations received by wholly religious institutions shall remain exempt from tax.

b. In the case of partly religious and partly charitable institutions, anonymous donations to medical or educational institutions run by them will be taxable at 30 per cent if the same exceed 5 per cent of total donations received by such trust/ institution or Rs. 1 lakh, whichever is more. Donations to partly religious and partly charitable institutions which do not run such medical or educational institutions shall remain exempt from taxation.

c. In the case of wholly charitable institutions, anonymous donations will be taxable at 30 per cent if such donations exceed 5 per cent of total donations received by such trust or institution or Rs. 1 lakh, whichever is more.

4.18.2 Points of Investigation

a. The Assessing Officer should examine whether the names and addresses of all the donors has been submitted by the trust or institution.

b. The Assessing Officer should examine whether the trust or institution has got registered u/s 80G. In such case, religious activities cannot exceed 5% of its total income during the previous year. Since, exemption from Section 115BBC is available only to religious institutions hence generally, both 80G and anonymous donations exceeding specified limit should not be allowed.

4.19 Carry Forward of Losses

4.19.1 A trust or institution is required to apply 85% of its income during the year. Thus it can accumulate 15% of its income without any condition or intimation. For accumulating more than 15%, filing of Form-10 is required as discussed earlier. In case a trust applied

more than 85% of its income during the year, it claims carry forward of such excess application. The Hon'ble Supreme Court in miscellaneous application No. 941/ 2018 IN CIVIL APPEAL NO(s). 5171/ 2016 in the case of Commissioner of Income-tax(Exemption) New Delhi–Vs-Subros Educational Society, vide order dated 16th April, 2018 has allowed carry forward of excess surplus.

4.19.2 Points of Investigation

a. What is the source of funds out of which excess application has been made?

b. Whether the carry forward has been claimed in the return of income?

4.20 Liability to Deduct TDS: As per explanation (iii) to Section 11(1) and 12th proviso to Section 10(23C) w.e.f. A.Y.2019–20, provisions of Section 40A(ia) and 40A(3) and 40(3A) shall be applicable while arriving at amount of application allowable to the assessee. Thus in case a trust or institution fails to deduct TDS on an application, 30% thereof will be disallowed. Similarly, where payment has been made otherwise than through account payee cheque, exceeding Rs. Twenty Thousand rupees the same will not be allowed as application.

5. FORFEITURE OF EXEMPTION AND ITS CONSEQUENCES

Section 13 mentions the circumstances under which benefit of provisions of Section 11 and Section 12 shall not be available to an assessee. These circumstances are listed as under:

a. Income from property held under trust for private religious purposes and not for the benefit of public;

b. Income of a charitable trust or institution created or established for the benefit of a particular religious community or caste (other than SC/ ST/ Backward Classes, women and children);

c. Income of a charitable or religious trust or institution under whose terms or rules any part of its income directly or indirectly benefits the author/ founder/ trustee/ manager or other such person specified under Section 13(3)

d. Income of a charitable or religious trust or institution if any part of its income or property is used or applied during the previous year either directly or indirectly for the benefit of any person specified under Section 13(3);

e. Income of a charitable or religious trust or institution, if any of its funds are invested or continue to remain this restriction will not apply to a "religious" trust or institution.

f. invested otherwise than in the modes specified under Section 11(5) during the previous year (this is subject to certain specified exceptions such as assets held as corpus, accretions to the same by way of bonus shares, debentures acquired under certain circumstances etc.);

g. Income of a charitable trust or institution engaged in the advancement of "any other object of general public utility" if it involves carrying on of any trade, commerce or business activity.

Provisions of Section 115TD may be invoked in case of circumstances provided in Section 115TD.

6. OTHER ASPECTS OF INVESTIGATION

6.1 Influential people build empires. There are educational empires also. It is a common sight-a person who has had his field day in some other field like politics, starting a host of educational institutions. Such institutions offer a safe haven for the black money earned elsewhere along with the scope for earning more money. They pass off as educational or charitable institutions. In such cases, a certain amount of enquiry and

investigation is necessary in respect of donations claimed as received, expenses incurred and amounts applied.

6.2 In the case of an orphanage which gives children in adoption, scrutiny should be intense. Such orphanages usually receive donations (mostly from abroad) towards rearing expenses of the children. While giving away the child in adoption they again collect the entire expenses from the adoptive parents. It should be checked whether the collections are duly accounted for.

6.3 Instances are not rare where black money of persons associated with trusts are introduced into the trusts as donations received from others. In one instance the employees of a bank-even those working in far-off branches-with which the person had accounts were issued receipts for supposed donations. While the person got his black income 'whitened', the employees got deduction *u/s* 80 G for donations not given! In such cases the person is not likely to be charitably dispositioned. In all probability what he creates is a business edifice disguised as charity. Such cases can be attacked from both the donation angle and the application angle. Probing the immediate source of the donor for the donation and a reference to his bank account will be rewarding. In all likelihood, the source-money would have come into the account just that day or a few days before. The supposed donor's history also will reveal some interesting aspects. How the donor came to know of the trust will be another relevant question.

6.4 There are some trusts that are in the habit of issuing receipts for supposed donations which had not in fact been received. What they get from the unscrupulous 'donor' is, not donation of the full amount, but a fraction-as commission. This helps the donor to claim deduction for the 'donation'. Enquiries on the lines similar to the above will help.

7. COORDINATION WITH OTHER AGENCIES

7.1 The trust or institution should have legal existence to qualify for exemption *u/s* 11. For a society or company to retain the legal status it is necessary that it should have registered with the concerned Registrar and should stay so. Once its name is struck off the registers of the Registrar it loses its legal personality. Enquiries with the Registrar will be necessary in doubtful cases.

7.2 Trusts engaged in social work have considerable interaction with State government agencies. Enquiries with these agencies help in ascertaining the real state of affairs. Laws governing local self government (municipal authorities) provide for concessional treatment to charitable institutions. The treatment accorded by the local authority to the institution concerned is relevant for tax investigations.

7.3 The Charity Commissioner functioning under the Bombay Public Trusts Act 1950 in Mahrashtra and Gujarat exercises general superintendence over the affairs of charitable organisations. He is empowered to sanction sale, mortgage, exchange, gift or lease of immovable property, hold enquiries, order special audit of the accounts, frame or modify a scheme and give notice for cy pres application. Liaising with his office may be useful in trust investigations.

7.4 In states like Tamilnadu, the agricultural income of charitable institutions is exempt for state agricultural income-tax purposes only if the conditions for registration, application/ accumulation of income, bar against benefit to interested persons, etc., under the Income-tax Act in 1961 are met. Even an institution with only agricultural income is required to register *u/s* 12A with the CIT/ DIT and fulfill all the conditions prescribed in Sections 11 to 13. Cases of agricultural income not fulfilling these conditions should be reported to the Agricultural Income-tax authorities.

8. CONCLUSION

8.1 The idea behind the exemption provisions in tax law is to regulate the affairs of the organisations which claim to be charitable. Here, we are dealing with a special category of

assessees who have come into being with the stated purpose of doing or promoting charity. The focus, then, should be on encouraging real charity-on detecting violations and meting out appropriate tax treatment and on identifying fake organisations and denying them the exemption. Making big tax demands and collections cannot by itself be the aim of any investigation. Obsession with law often blunts investigations. The AO should not get carried too far by legal issues. The focus should be essentially on facts. Any claim made should be checked for factual veracity. If the AO fails to bring out relevant facts, Department's case is lost for ever.

8.2 Investigation in trust cases should be purposeful, specific and pointed, as any investigation should be. The AO should have a clear idea of what he is seeking to achieve. He should steer clear of foggy thought processes. While investigating, the AO should be familiar with the case law on the point.

8.3 There are several trusts created with anything but a charitable intention. Their objects are noble, but activities are not. Many of them are just money-spinning mechanisms. That the Legislature is aware of this evil is evident from the attempts it makes year after year to contain it. The AO should keep in mind the larger social considerations while making investigations. He should be firm and unsparing with such trusts. But he should be discriminating enough to spare the really good organisations from any destructive scrutiny.

CHAPTER

20

Educational & Coaching Institutes

1. SALIENT FEATURES

1.1 Educational institutions functioning in India are owned and managed either by public trusts or by societies registered under the Societies Registration Act of 1860. In some of the States, for example, Maharashtra and Gujarat, where local Public Trusts Acts have been passed, all the societies registered under the Societies Registration Act, are required to be simultaneously registered under the local Public Trusts Act.

1.2 The public trusts are generally managed by Board of Trustees, one of whom may be designated as Chairman or Managing Trustee. Societies are autonomous bodies with office bearers consisting of president, vice-president, secretary, treasurer and executive committee members. The general body consists of all the members of the society. Societies/ trusts which run number of colleges, schools, etc., have a governing body for managing the affairs of each individual school or college, wherein head of the school/ college such as the principal of the college or the head master of the school may be inducted as a member of the governing body. The responsibility of governing body is to manage the affairs and ensure smooth functioning of individual school or college.

1.3 The colleges which are affiliated to the State/ Central level Universities under the relevant University Act are required to have a governing body or managing committee to manage the affairs of the college concerned. The governing bodies/ managing committees of educational institutions may be supported by various committees, e.g. finance committee, library committee, science committee, sports committee, etc. for streamlining of the decision-making process. Members of such committees may be the members of governing body, teaching faculty and administrative staff depending upon the nature of the functions of the committee.

1.4 Educational institutions which fulfill the eligibility requirements laid down by the Government are eligible to get assistance in the form of Grant-in-aid from the Government. The grants are released on the basis of audited statements of accounts of the educational institutions. Apart from grant, part of the

expenses of the educational institutions are met from the funds raised by the educational institutions themselves, either by way of fees, or from donations collected from public.

2. EXEMPTION OF INCOMES OF CERTAIN EDUCATIONAL INSTITUTIONS AND PROVISIONS RELATING TO TRUSTS RUNNING EDUCATIONAL INSTITUTIONS

2.1 In Indian taxation, educational institutions enjoy a privileged position. There are many tax exemption regimes available to educational institutions depending upon their constitution, objects, gross annual receipts and level of government finance they receive. Broadly, Section 10(23C) and Section 11 of the Income-tax Act contain the provisions applicable to educational institutions. The contents of the succeeding paragraphs provide an overview on principles involved in taxation of income of educational institutions in India.

2.2 Education is treated as a noble occupation on 'no-profit-no-loss' basis. It is for this reason that a recognised educational institution can only be run by a non-profit organisation (hereinafter NPO for brevity), be it a "Trust" or a "Society" or "a Section 8 Company". Despite such honourable position endowed upon them, it is seen that some of the Educational Institutions have become the highest grossers of unaccounted wealth in the recent past. Those who establish and are managing the educational institutions are not expected to indulge in profiteering or commercialize this noble activity. However, in reality, the situation is not apposite to such principled intentions.

2.3 Though education is now treated as an 'occupation' and, thus, has become a fundamental right guaranteed under Article 19(1) (g) of the Constitution, at the same time shackles are put in so far as this particular occupation is concerned, which is termed as noble. Therefore, profiteering and commercialization are not permitted and no capitation fee can be charged.

2.4 The Constitutional duty of the governments, both Central & State, is to ensure that educational institutions were not indulging in commercialization and to make sure that institutions function to spread education and not to make money. The Income-tax Department thus possesses the foremost responsibility to check such maleficence by appropriate provisions under the Act. The job of the Assessing Officer of the Educational Institutions, therefore, is characterized rather as a watchdog and not as a tax collector.

2.5 Before claiming the applicable exemption under the Income-tax Act by any educational institution, there should be a legally existent entity which can be registered and it should have a written instrument of creation or written document evidencing its creation. A NPO can be created only in 3 major forms. The first one being the Trust, is the most common mode of creation. The next form is that of a Society registered under the Societies Registration Act, 1860. The third form and the least opted is that of a Section 8 Company registered under the Companies Act, 2013.

2.6 These 3 types of non-profit organisations have to get registered before the Commissioner of Income-tax (Exemptions) under S.12AA of the Act in order to enjoy the benefit of exemption *u/s.* 11. In respect of a Society or a Section 8 Company, registration is mandatory under the respective Acts. In respect of a Trust, there is no compulsion that it has to be registered under the Indian Trust Act, 1882. Even oral Trusts are eligible for registration under S.12AA. However, the purpose of the Trust, and the bye laws governing the Trust activity should be drawn up in writing while filing the application in Form 10A.

2.7 The provisions of S.11 & 12 apply to an assessee, either it be a Trust or a Society or a Section 8 company. However, the provisions of S.10(23C) applies to an institution operating under the aegis of a Trust or a Society or a Section

8 company. This distinction has to be borne in mind while granting approval u/s. 10(23C). The similar provisions are applicable to Section 80G as well, which applies to an institution and not that of an assessee. The contents of the provisions of Section 10(23C) and Section 80G are "qua institution" while that of S.11 and 12 are "qua person."

2.8 Small educational institutions get covered under Section 10(23C)(iiiad) which reads as follows: *"(iiiad) any university or other educational institution existing solely for educational purposes and not for purposes of profit if the aggregate annual receipts of such university or educational institution do not exceed the amount of annual receipts as may be prescribed;"*

2.9 Thus, institutions existing solely for educational purposes and not for profit whose aggregate annual receipts do not exceed ₹1 crore [Rule 2BC of the I.T. Rules] are eligible for tax exemption without any need for separate registration under Income-tax Act. For purpose of exemption under Section 10(23C)(iiiad), 'aggregate annual receipts' refers to receipts by educational institution and not that of Society. Receipts from more than one educational institutions run by assessee cannot be clubbed for the purpose of denying exemption under Section 10(23C)(iiiad).

2.10 Educational institutions existing solely for educational purposes and wholly or substantially financed by Government are exempt from tax as per Section 10(23C)(iiiab) without any need for separate registration under the Income-tax Act: *"(iiiab) any university or other educational institution existing solely for educational purposes and not for purposes of profit, and which is wholly or substantially financed by the Government; or"*

2.11 The phrase 'wholly or substantially financed by the Government' is explained by CBDT through Notification No. 79/ 2014 by way of insertion of Rule 2BBB as follows: *"2BBB. For the purposes of sub-clauses (iiiab) and (iiiac) of Clause (23C) of Section 10, any university or other educational institution, hospital or other institution referred therein, shall be considered as being substantially financed by the Government for any previous year, if the Government grant to such university or other educational institution, hospital or other institution exceeds fifty per cent of the total receipts including any voluntary contributions, of such university or other educational institution, hospital or other institution, as the case may be, during the relevant previous year."*

2.12 Other educational institutions not covered under sub-clause (iiiab) or (iiiad) of Section 10(23C) are dealt with by Section 10(23C)(vi) as follows: *"any university or other educational institution existing solely for educational purposes and not for purposes of profit, other than those mentioned in sub-clause (iiiab) or sub-clause (iiiad) and which may be approved by the prescribed authority;"*

2.13 Thus, institutions existing solely for educational purposes and not for profit which are not wholly or substantially financed by Govt. and aggregate annual receipts of which exceeds ₹1 crore, are required to obtain approval of Commissioner/ Principal Commissioner of Income-tax by applying in prescribed form No. 56D. [Rule 2CA of I.T. Rules]

2.14 Some salient features of approval u/s. 10(23C) (vi) of the Act are:

a. The "educational institutions existing solely for educational purposes and not for purposes of profit" are only eligible for approval.

b. Any activity of the approved institution or amendment in object Clause by such institution which is not solely for educational purposes will result into cancellation of approval.

c. No exemption u/s. 10(23C)(vi) shall apply in relation to any income of any university or other educational institution being

profits and gains of business, unless the business is incidental to the attainment of its objectives and separate books of accounts are maintained by it in respect of such business. [Fourth proviso below sub-clause (vi) of Section 10(23C)]

d. No exemption shall be allowed by the Assessing Officer under any of the Clauses of Section 10(23C) in the case of an institution for a previous year, if the provisions of the proviso to Section 2(15) become applicable in the case of such person in such previous year. [Seventeenth Proviso to Section 10(23C)].

e. CBDT Circular No. 14/ 2015 dt. 17.08.15 Clarifies on certain issues related to grant of approval and claim of exemption *u/s.* 10(23C)(vi) of the Income-tax Act, 1961.

f. Principles laid down by the Apex Court in American Hotel and Lodging Association Educational Institute *vs.* CBDT [301 ITR 86 (2008)] must be followed while considering the applications filed seeking approval for exemption *u/s.* 10(23C)(vi).

g. Section 10(23C)(vi) does not prescribe any stipulation which makes registration *u/s.* 12AA a mandatory pre or post condition. Hence obtaining prior registration before granting approval *u/s.* 10(23C) cannot be insisted upon.

h. Mere generation of surplus by educational institution from year to year cannot be a basis for rejection of application *u/s.* 10(23C)(vi) if it is used for educational purposes unless the accumulation is contrary to the manner prescribed under law.

i. Collection of small and reasonable amounts under different heads of fee, which are essentially in the nature of fee connected with imparting education and do not violate any Central or State regulation does not, in general, represent a profit making activity. Hence, there is no justification for treating the charging of small amounts under different heads of fee as profit making activity unless the amount in the nature of 'capitation fee' is charged directly or indirectly.

2.15 Educational Institutions can alternatively claim exemption *u/s.* 11 r.w.s. 2(15) of the Act on the basis of its registration as charitable NPO/ Institution *u/s.* 12AA. In an event it is found that the educational institution does not fulfill the condition laid down *u/s.* 10(23C), except in the case of invoking proviso to Section 2(15) read with 17th proviso to Section 10(23C), the Assessing Officer is not empowered to undertake the assessment and complete it disentitling the assessee from claim of exemption *u/s.* 10(23C) unlike that of denial of exemption *u/s.* 11 r.w.s.13.

2.16 In case of violations to the provisions of Section 10(23C), the Assessing Officer has to keep the proceedings in abeyance as per proviso to Section 143(3) till such time the intimation about the contravention reported to the approving authority is acted upon. Alternatively, if the assessee/ person is found eligible for exemption *u/s.* 11 due to fulfilment of conditions laid down therein, the educational institution can be alternatively extended the benefit of Section 11.

2.17 Filing of Return of Income: As per Section 139(4A), every charitable/ religious NPO, if its total income (the total income for this purpose being computed under this Act without giving effect to the provisions of Sections 11 and 12) exceeds the maximum amount which is not chargeable to Income-tax, shall furnish a return of such income of the previous year in the prescribed form and all the provisions of this Act shall, so far as may be, apply as if it were a return required to be furnished under sub-section (1).

2.18 As per sub-clause (e) to Section 139(4C) of the Act, every university or other educational institution referred to in sub-clause (iiiab)* or sub-clause (iiiad) or sub-clause (vi) of Clause (23C) of Section 10, shall, if the total income in respect of which such university or other educational institution is assessable, without giving effect

to the provisions of Section 10, exceeds the maximum amount which is not chargeable to Income-tax, furnish a return of such income of the previous year in the prescribed form and all the provisions of this Act shall, so far as may be, apply as if it were a return required to be furnished under sub-section (1).

2.19 With effect from A.Y. 2018–19, no exemption *u/s.* 11 can be claimed by any NPO unless it has furnished a return of income in accordance with provisions of sub-section (4A)/ (4C) of Section 139, within the time allowed under that Section. [S. 12A(1)(ba)]

2.20 Furnishing of audit report: Where the charitable NPO/ institution claiming exemption *u/s.* 11 is liable to file return of income as above, it is also liable to get is accounts audited and furnish audit report in form 10B. [Section 12A(1)(b) r.w.r. 17B]

2.21 Where the educational institution referred to *u/s* 10(23C)(vi) is liable to file return of income as above, it is also liable to get its accounts audited and furnish audit report in form 10BB. [Tenth proviso to Section 10(23C)(vi) r.w.r. 16CC]

2.22 Income-tax Act favours only genuine educational institutions/ NPOs subject to approval/ registration under the Act, wherever necessary. And, if there is any deviation from basic objective of imparting education by such institutions to make profits, the Act is well equipped to bring this mischief within the tax bracket. There is no bar in undertaking commercial activities by such institutions, so long as these activities are incidental and essential in the given circumstances in order to achieve the prime objective of education. As far as any other object of general public utility pursued by these institutions is concerned, commercial activities are permissible only to certain extent and only if these activities are incidental to the attainment of such objects.

3. RECORDS TO BE MAINTAINED BY EDUCATIONAL INSTITUTIONS

3.1 Educational institutions are required to maintain proper books of account so as to comply with the terms and conditions laid-down for the purpose of grant and also to comply with the provisions of the Societies Registration Act, 1860 or the provisions of the Public Trusts Act as may be applicable and as may be in force in the State in which the Institution is situated. In addition, the provisions regarding maintenance of accounts contained in the trust deed/ rules and regulations of the institution will also have to be complied with. Normally, an educational institution is expected to keep such books as are necessary to give a true and fair view of the state of affairs and income and expenditure of the institution. It must also ensure that there is effective internal control system in operation.

3.2 Educational institutions generally maintain Cash Book, Bank Book, Journal, General Ledger, and subsidiary Ledgers. Besides, they also maintain following records:

a. Fees registers (to record admission fee, tuition fee, library fee, examination fee)
b. Register for Grants-in-aid.
c. Register for scholarship and special stipends.
d. Registers for funds such as building, library, laboratory, games, furniture and equipment, endowment, provident fund, poor students fund, deposits etc.
e. Register of immovable properties and other fixed assets.
f. Register of investments.
g. Minute books.

4. SOURCES & APPLICATION OF FUNDS OF EDUCATIONAL INSTITUTIONS

4.1 The main sources of funds of educational institutions are as under:

a. Educational institutions are permitted to collect tuition fees, admission fees, development fees, sports fees, examination fees, library fees etc., from the students as per the rules and limits prescribed by the Government. No fees other than those permitted can be collected.

b. The subscriptions, donations or endowments from the public may be received either in cash or in kind to meet recurring or nonrecurring expenditure of the institutions like construction of buildings, repairs, scholarships etc. The donations in kind can be in the form of land, buildings, shares, securities, utensils, furniture, fixtures and the like.

c. Grants from State Government, Central Government and the University Grants Commission. From the accounting point of view, the grants are classified as recurring & non-recurring grants.

(i) Recurring Grants, in the form of maintenance grants, are received in installments throughout the year. The formula for payment of maintenance grants differs from State to State. In some cases the percentage of permissible expenditure is reimbursed to the institutions, while in other cases entire admissible expenses of the institution are borne by the Government and in addition a fixed percentage of admissible expenditure is given for contingent expenses.

(ii) Non-recurring Grants from the Government are in respect of building, furniture, library, laboratory and other equipment. Building grants are sanctioned to the educational institutions for the purposes of erecting, purchasing, expanding or reconstructing school buildings. The building grants usually constitute a percentage of the total expenditure.

(iii) Educational institutions also earn interest/ dividends from investments in government securities, debentures and shares, and deposits with banks and post offices etc..

(iv) Educational institutions may, in some cases, derive income by way of rent by letting out its premises.

(v) Educational institutions also receive grants from local authorities or other charitable institutions for payment of scholarships, stipends and other concessions to the students. The institution will have to conform to the stipulations of such authorities/ institutions, as per which the grant is sanctioned.

4.2 Educational institutions generally incur recurring expenditure under the heads of salaries and allowances to teaching and non-teaching staff; training expenses; rent, rates, taxes and insurance; Repairs and maintenance; stationery, printing, postage; telephone; electricity; laboratory; drawing material; library; prizes and medals; etc..

4.3 Educational institutions also incur nonrecurring expenditures on such items, as Construction of building; purchase of furniture/ office equipment/ library books/ laboratory equipment/ sports equipment/ teaching aids/ and other assets.

5. ISSUES FOR VERIFICATION

5.1 On the Receipts Side

a. It is always advisable to have the knowledge of the local Trust Act of the State in which the institution is located, and to familiarise with the regulations of the State Government regarding incorporation, functioning, supervision and control of educational institutions. Thereafter, the basic documents evidencing the constitution of the educational institution i.e., the Memorandum, Rules, Trust Deed etc. must be studied.

b. Minute book of the meetings of the managing committee/ governing body contains valuable information which enable to comprehend salient developments/ events having bearing on the accounts.

c. In case the institution has its own accounting manual or instructions, these may be examined.

d. The latest audit report along with particulars of preceding 2 to 3 years may be studied to examine the observations/ qualifications made by the Auditors therein.

e. In serious investigation cases, the Fee collection register and other similar record can be examined to verify the amounts receivable from students on account of- admission fee; tuition fee; library fee; examination fee; laboratory/ science fee; sports fee; fines; miscellaneous charges;contribution (for funds etc..); Hostel room/ service charges;mess & other charges. It may be worthwhile to check whether the amounts shown as recoverable in the register of fees and charges are based on rates applicable/ stipulated for each category of students; and whether the names of all students on the rolls of the institution have been duly entered. It may also be examined whether bills have been raised, at prescribed intervals in respect of all the students on the rolls of the institution.

f. Most of the donations are received towards corpus. Therefore, it is often necessary to verify whether donations received are properly recorded in separate accounts depending on the nature of and the purpose for which the donations/ endowments were given, i.e. towards corpus; or for a specific purposes, e.g., for purchase of capital equipment, grant of scholarships, awards etc..; or for general purpose, as evidenced by the communication from the donors indicating their intention/ purpose. Certain institutions receive donations in cash which are not accounted in the books of accounts at all.

g. It may be verified whether interest earned on fixed deposits, loans and securities have been accounted or not. It may also be ascertained whether interest accrued but not received on loans have been accounted or not where the institution is following mercantile system of accounting. In this context, bank accounts can be examined on test check basis to ascertain that interest received is being accounted properly.

h. Amounts due on account of lease money/ rent as per to the terms of the lease deed/ rent deed entered into in respect of any portion of the premises let out by the institution, may be checked. Records pertaining to temporary hire/ rental of the premises of the institution, e.g., for functions, examinations etc.., may be examined to ascertain whether recoveries have been made and recorded at the stipulated rates.

i. It may also be worthwhile to verify the nature of the various grants applied for and sanctioned in favour of the institution and whether grants-in-aid are being recorded in the books of account based on their nature and the purposes for which such grants are sanctioned-particular care being taken to segregate recurring and nonrecurring grants and those on capital account or otherwise.

j. Reference may also be made to the related discussions in the Chapter relating to 'Charitable trusts and institutions'.

5.2 On the Expenditure Side

a. The remuneration payable to various functionaries may be checked with respect to the terms and conditions of appointment

to each category of staff employed by the institution. Many institutions obtain receipts for higher amounts from their employees towards salary but the actual salary paid to them is much less. The difference amount is secreted away as concealed income. If necessary, statements of some of the employees can be recorded to ascertain the true facts.

b. It may be checked whether scholarship amounts have been disbursed to eligible students in accordance with the criteria laid down by the institution or the terms laid down by the donors in case scholarships are out of endowments/ grants etc.

c. In case of residential schools, expenses on purchases, food grains, provisions, electricity, water, rent, repairs, maintenance etc., may need verifications. Often, these expenses are inflated to generate unaccounted cash.

d. The correspondence regarding sanction/ disbursement of various grants can be examined to ensure that expenditure incurred in respect of grants for specific purposes, is strictly in accordance with the terms and conditions stipulated. The utilisation of grants and expenditure incurred can be checked with reference to–the original evidence/ supporting vouchers; entries in the cash book and bank statements; minutes of the managing committee/ governing body as regards sanction of expenditure; and utilisation certificates, if any, furnished to the authorities concerned as per the terms of the grants.

e. It may be necessary to verify the terms and conditions of loans; whether loans have been taken on proper authority or not; and whether these have been Utilised for the specific purposes of the educational institution or not. Often, loans obtained are diverted to sister concerns without charging interest.

f. It is also necessary to check whether security deposits received from the students during the previous year have been accounted. Similarly, refund of security and other deposits to students, may be checked with reference to the acknowledgments from them on final settlement of dues. Often, security deposit is not refunded to some or many students at the time of leaving of the school, however, an acknowledgment in that regard is obtained from the student/ parent. In cases of such an allegation, the mode of payment i.e., cheque or cash may be verified and in case it is felt necessary the cross verification from the student/ guardian may be made.

g. Often fixed assets are purchased at inflated prices from connected parties etc.. The excess money charged flows back to the management/ controlling body. In appropriate cases fixed assets may be physically examined and their type, make, model, quality etc., may be noted down and the market price of similar items may also be ascertained by local enquiry to ascertain whether the assets have been purchased at inflated rates.

h. Often, surplus funds of the institution are diverted to sister/ group concerns of the main persons managing the institution. This aspect must be borne in mind, with reference to provisions of Section 13.

i. Where any loans have been granted, the authority and terms and conditions of such loans may be verified. It may also be seen whether recovery of the principal and interest amount is in accordance with the stipulated terms and conditions or not, and whether there is any nexus between persons controlling the institution and the person to whom the loan has been given.

j. It is also necessary to verify whether any expenditure (capital or revenue) has been incurred or any property or funds applied for objects and purposes other than those contained in the Trust Deed, Memorandum/ Rules of Society etc.

6. OTHER RELEVANT ISSUES RELEVANT FOR EDUCATIONAL INSTITUTIONS

6.1 Charity delayed is charity denied. The income-tax department acts as a major catalyst in fostering charity and ensuring that the beneficiaries receive the benefits as swiftly as possible. It is for this reason that the provisions of Section 11 and third proviso to Section 10(23C) mandates that 85% of the income received during the year has to be applied within the year, the exceptions being Explanation 2 to Section 11 and Section 11(2). Corpus donations received by a NPO is exempt *u/s.* 11(1)(d) and the NPO need not apply 85% of corpus donation.

6.2 The most common method in denying charity to beneficiaries and accumulating large reserves within the NPO is executed by granting corpus donations to other NPOs with similar objects. Donation to another NPO was treated as application of income in the hands of the donor NPO. However, the recipient or the donee NPO has to apply 85% of such income received as donation within the year *u/s.* 11(1) or within the next year in case of exercise of the provisions of Explanation 2 to S.11(1)(a).

6.3 A major educational institution created 7 satellite trusts with similar objects. The trust had an income of ₹200 crores approximately per annum. It would be applying 70–80 crores for running and maintenance of the educational institution. The difference between the amount applied and 85% of the income was donated to these 7 satellite trusts. In order to rescind from passing on the benefit to the beneficiaries, the donor trust would donate funds as corpus donations to the recipient. By applying the provisions of Section 11(1)(d), the donee would desist from applying such income. This scheme of denial of charity while at the same time enjoying the benefits of deduction *u/s.* 11 was finally curtailed by the Finance Act, 2017 which inserted a provision explaining that corpus donations made to another trust will not be treated as application of income.

6.4 Certain educational institutions which derive substantial income siphon off the funds for private benefit of the Trustees without passing the transactions through the books of accounts. The most common practice is by granting construction contracts, service contracts and supply contracts to the concerns run by the Trustees or their relatives. Such contracts are marked up with huge profit per centage, which are not at arm's length or as per prevailing market rates. Therefore, in case the contracts are not awarded to any reputed person and more particularly if it is given to a related enterprise, such transactions should be examined thoroughly. Transactions with persons specified in Section 13(3) by an educational institution is not prohibited. However, the transactions have to be at arm's-length as determined *u/s.* 13(2) of the Act. In case of construction contracts, reference have to be made to the valuation cell for determining the cost of construction. Similarly, all other contracts awarded by the educational institution to such related persons have to be verified and any amount paid in excess of the fair market value will end up in denial of exemption *u/s.* 11 r.w.s.13(1)(c).

6.5 A Trust running a medical college in South Tamilnadu was in receipt huge capitation fees for admitting students and an action *u/s.* 132 undertaken substantiated the allegation to be true. The contents of the seized material revealed that the trust had given ₹17.25 crores as donation to another trust in Kerala to seek admission in MBBS stream for the daughter of the Managing Trustee. The medical college had also taken a building on hire for a rent of ₹1 lakh per month. However, the intriguing part was that the medical college had paid a rental advance of

₹3 crores to the Managing Trustee, the owner of the building hired. The rental advance was 300 times the monthly rent which was exorbitant and unreasonable when compared to the market practice where the maximum advance paid is 10 months rent. This was a clear violation *u/s.* 13(2) r.w.s.13(1)(c) and the entire income of the Trust has to be brought to tax denying exemption *u/s.* 11. Even the grant of donation to another trust was reciprocated by a private benefit to the Managing Trustee and the violation *u/s.* 13(1)(c) was proven on an additional count. However, due to lack of understanding, the Assessing Officer instead of denying deduction *u/s.* 11 highlighting these issues, had disallowed these payments as ineligible expenditure. Despite the establishment of fact that the Trust had received substantial capitation fees and had also violated the provisions of Section 11 r.w.s.13(1)(c), the improper appreciation of the provisions of taxation governing Trusts has resulted in framing a incongruous order which did not stand the test of appeal.

6.6 It is necessary that the principles of taxation of NPOs are understood properly, essentially distinguishing the methodology involved in comparison to other profit making assessees. The income of a profitable organisation is determined as per "P&L account or Income & Expenditure account" while that of a NPO is neither of these and is determined as per "Receipts & Payments account". Here, there is no distinction between capital receipt or revenue receipt. Even donations are treated as income *u/s.* 2(24)(iia). Similarly, there is no distinction between capital expenditure or revenue expenditure. Either way, irrespective of their nature, they are classified as "application of income". The NPO does not earn any profit or loss. It is either "Excess of receipts over payments" or "Excess of payments over receipts". The application of income should only confer benefits to the beneficiaries, irrespective of caste, community, creed or religion, identified in the deed of NPO and not to anyone else. In case of benefit being conferred on persons specified *u/s.* 13(3) excluding the situation narrated in Section 12(2), the NPO loses exemption *u/s.* 11 for all the years of such violation and the entire income has to be taxed. In case the benefit neither reaches the beneficiaries nor the persons specified *u/s.* 13(3), then such quantum of benefit will be ineligible for exemption *u/s.* 11 to the extent of such diversion as per Section 11(3) and the balance income would continue to enjoy exemption, as long as it complied to the provisions of Section 11.

6.7 The NPO has to apply 85% of its income during the year. In case of shortfall, as long as it complies to the other provisions *u/s.* 13, the difference between the amount applied and 85% of the income has to be brought to tax. The exceptions are provided only when the assessee resorts to postponement by a year as per Explanation 2 to Section 11(1) or defers it by 5 years as per Section 11(2). If the NPO invokes the provisions of Explanation 2 to Section 11(1), the income to the extent not considered for application during the year can be postponed by a year only.

6.8 The provisions also provided for long term deferral of application of income. If the NPO envisages a major and concrete expenditure, it can postpone the application of income by specifying the purpose of application in Form No. 10 after passing a resolution to such effect and file the same alongwith the return of income before the 139(1) limit. The purpose of accumulation has to be specific, confined to the objects of the NPO and cannot be general in nature. It has to be one amongst the multifarious objects for which the NPO stands created. In case the purpose for which it is accumulated is defeated or if the period of 5 years lapses or if such funds are donated to another NPO, then the accumulated sum would become taxable in the year of diversion. In case of lapse, wherein, the accumulated income is not Utilised within a period of 5 years, such income has to be treated as taxable income in the financial year succeeding the last day of the 5th financial year.

The NPO is not allowed to roll over the same for a further period of 5 years and the same has to be brought to tax as such. Since the provisions of Section 11(3) empowers the Assessing Officer to tax such non application of income, there is no need for cancellation of registration *u/s.* 12AA(3).

6.9 In case of educational institutions approved *u/s.* 10(23C)(vi), 85% of the income has to be applied failing which the difference between the amount applied and 85% of the income is deemed to be automatically accumulated. There is no necessity on the part of the educational institution approved *u/s.* 10(23C)(vi) to file Form No.10, since such educational institution exists for a solitary object to foster education only. However, in case of violation to the conditions laid down under third proviso to Section 10(23C), the Assessing Officer cannot bring such unutilised sum to tax directly. The 13th proviso to Section 10(23C) has to be invoked by the competent authority and only after the approval granted *u/s.* 10(23C)(vi) earlier, is withdrawn, the Assessing Officer can bring such unutilised sum to taxation. The competent authority is either the Chief Commissioner of Income-tax or the Commissioner of Income-tax (Exemptions) of that region. Since prior to 15/ 11/ 2014 approvals *u/s.* 10(23C)(vi) were granted by the Chief Commissioner of Income-tax, in case of violations reported by the Assessing Officer, the CCIT should alone pass the order for rescinding the approval granted earlier. In case of approvals granted from 15/ 11/ 2014, the cancellation can be undertaken by the CIT(Exemptions).

6.10 A NPO derives income either by way of donations (excluding corpus donations) defined in Section 2(24)(iia) or derived from property held under the Trust. The properties can be of any kind which include business held under the Trust. As per Board's circular in No. 5-P(LXX-6) of 1968, dated 19-6-1968, expenditure to earn income from properties held under Trust will not be treated as application of income. It is only the surplus generated from the rental activity, business activity incidental to the objects and income from other sources is to be treated as income for the purposes of Section 11 and 85% thereof should be applied.

6.11 An educational institution, apart from operating a school or college, would be running various business activities *viz.*, plying of transport, selling books/ uniforms, running mess/ canteen/ hostels etc. These businesses do not impart a characteristic of commercialization to the educational institution as long as such business activity is incidental and allied to the main activity of imparting education. However, in such area of activity, the quantum of income for the purpose of Section 11, is the surplus generated from such business. The expenditure to earn income by these businesses cannot be treated as application of income. The educational institution has to thereafter apply 85% of the surplus in order to be eligible for exemption *u/s.* 11. This rule applies for rental income and income from other sources as well. For example, if the educational institution receives a rental income of ₹1 crore and spends ₹40 lakhs as expenditure towards maintenance, the income for the purpose of Section 11 of the educational institution is ₹60 lakhs and 85% of ₹60 lakhs being ₹51 lakhs has to be applied. Generally, while computing the income and application of income, assessees resort to treating ₹40 lakhs spent to earn the rental income as application of income and firm up an opinion that it has to further spend ₹45 lakhs to be eligible for exemption *u/s.* 11. This arithmetic is incorrect and as per the provisions of the Act in the illustration provided the assessee has to spend ₹91 lakhs in order to establish the compliance to the provisions of Section 11. It is emphasized that this concept of computing income applies only to rental receipts, business activity and income from other sources and does not apply to the main charitable activity undertaken by the educational institution.

6.12 A NPO has to maintain its funds in modes prescribed *u/s.* 11(5) r.w.r.17C and any discrepancies/ violations to this mandate would result in invoking the provisions of Section 13(1)(d) resulting in complete of Section 11 exemption.

6.13 An educational institution is eligible for exemption *u/s.* 10(23C)(vi) only if the objects are wholly and solely educational in nature. In respect of NPOs governed by the provisions of Section 11, the objects can be multifarious. If such multiple objects pertain to one or more of the 6 main limbs of charity defined *u/s.* 2(15), the proviso to Section 2(15) would not come into play. However, even if one of the object relates to the residual category or the last limb of charity, being an object of general public utility, it gets classified as a GPU and hence proviso to Section 2(15) would automatically apply.

6.14 An NPO is characterised by its objects and not by its activity. A business undertaken by the NPO would not result in invoking proviso to Section 2(15) if the property being the business is held under trust. The proviso to Section 2(15) would apply only in an event that the property being business is held by the Trust.

6.15 An educational institution eligible for deduction *u/s.* 11 to remain free from the clutches of proviso to Section 2(15) should necessarily impart formal education, unlike coaching institutes, training centres, institutions rendering seminars, lectures, etc.,which do not fall under the main limb of charity being "Education" *u/s* 2(15) of the Act. They would however be treated as Charitable under the residual category and enjoy exemption *u/s* 11, provided proviso to sec 2(15) does not come into play, by virtue of the quantum of business activity, being informal education.

6.16 The capitation fees are prohibited under the law enacted by respective state governments under the Capitation Fees Prohibition Act and hence the NPOs would not show the corresponding receipts in the Receipts and Payment Account. However, the courts have taken a view that receipt of capitation fees is only prohibited under the State legislated Capitation Fees Prohibition Act and not under the Indian Income-tax Act. It is, therefore, suggested that in case of detection of unaccounted cash or undisclosed entries relating to such receipts care should be taken to bring the same to taxation under the provisions of Section 115BBC as an anonymous donation as categorising the same as Capitation fee receipt and bringing it to tax may not stand the test of judicial scrutiny.

6.17 The provisions of Section 133A has been amended w.e.f. 01/ 04/ 2017 to empower the Income-tax Authorities to undertake survey in case of a "Charitable Institutions" (Not to confuse with Religious Institutions) which was hitherto confined to a place of Business or Profession only. While undertaking investigation during the course of survey or search or at the time of post survey or post search proceedings or at the time of assessment proceedings, the focus of the Assessing Officer should be directed to check violations, diversion of funds for private purposes, etc. and not to approach in a fashion by which a business undertaking is dealt. The provisions of sections 10, 11, 12, 115BBC and 80G are self-contained to deny benefits and to bring the receipts to tax.

6.18 Some other methods of tax evasion noticed in the cases of educational institutions are listed below:

a. Cash donations are demanded and accepted from parents at the time of admission of the child/ ward without issuance of any receipt for the same.

b. Some educational institutions insist that donation be made to a particular charitable trust and receipt for a specified sum be obtained from that trust before admission is granted to the child.

c. The relatives of the trustee/ author of the trust are appointed to responsible positions in the institution and given handsome salary and perquisites not commensurate

either with their qualifications or the work done by them.

d. Property/ building etc., belonging to the relatives of the trust are leased out to the educational institutions. The lease rental, however, charged is quite high and not reasonable as per the market rentals for the same property.

e. Expenses relating to purchase of furniture, fixtures, books, stationery, computers etc., are inflated

f. Salary bill is inflated by paying amounts less than the amount for which receipts are obtained from the teachers.

g. Large sums are collected from students by way of donations are lent out to sister concerns without adequate interest.

h. The school runs ancillary services e.g. book shops, Shops for school uniform, school buses, etc. on commercial basis through its nominees. Often a separate firms are created to manipulate the income that is generated from such operations.

i. Since it is a statutory requirement for charitable trusts to apply 75% of their income to charitable activities, many institutions debit bogus expenses to obtain exemption *u/s* 11.

7. CASE STUDY OF AN EDUCATIONAL INSTITUTE AND A COACHING INSTITUTE

7.1.1 One Trust was running an Engineering College and specialized in imparting Maritime Engineering. It possessed substantial surplus and in order to gain better returns the Managing Trustee had purchased gold bullion worth Rs. 45 lakhs during the financial year 2009–10. Since investment in gold is a prohibited mode of investment *u/s*. 11(5), the Balance Sheet disguised the investment as on 31/ 03/ 2010 to be "Other Deposits". The books of accounts and bank statements were examined and it was found that cheques have been issued in favour of reputed jewellers and on further investigation, it surfaced that the investment to the extent of Rs. 45 lakhs was in violation of the provisions of Section 13(1)(d) thereby disentitling the Educational Institution from claim of deduction *u/s*. 11.

7.1.2 During the course of scrutiny proceedings, the Authorized Representative tried to impress that the bullion was purchased to convert them into gold medals and reward them to meritorious students. This claim was proven to be bogus since the bills for conversion of bullion into gold medals could not be produced. The name and identity of the meritorious students to whom gold medals were awarded were not submitted. Further on verification of the subsequent years financials, it was found that the equivalent quantity of gold was sold.

7.1.3 Armed with such evidences, apart from other discrepancies noted in the earlier years and continued in the year under consideration, the claim of deduction *u/s*. 11 was denied. The appeal before the ITAT was decided in favour of the department. While the assessee was able to obtain relief on all other issues, the act of invoking the provisions of Section 13(1)(d), since investment in gold was a prohibited investment *u/s*. 11(5), was upheld in favour of the Department.

7.2.1 An Educational Trust, running an Engineering College was undertaking continuous transactions similar to that of the current account with the Managing Trustee and his spouse. The provisions of Section 13(1)(c) comes into play only when the Trustee's accounts exhibit a debit balance in the books of the Educational Institution. The assessee Trust ensured that the year end values are credit balances.

7.2.2 During the course of scrutiny proceedings, the copies of ledger folio of the Trustees were obtained and on verification it was found that in the month of October, the accounts of the Managing Trustee exhibited a debit balance of Rs. 20,98,480. Since the violation resulted in

disqualification, the assessment was concluded denying exemption *u/s.* 11, since the Managing Trustee, a specified person *u/s.* 13(3)(cc) was conferred benefit in the form of an advance which was given without adequate security and adequate interest.

7.2.3 Before the Appellate Commissioner, the assessee pleaded that the wife of the Managing Trustee as on the date on which the peak debit balance appears in the books of the Trust in respect of the Managing Trustee, had a credit balance of Rs. 2,22,74,985. The Ld. CIT(A) set off the debit balance relating to the Managing Trustee with that of the credit balance of the spouse of the Managing Trustee and found that the consolidated value, being a credit balance does not result in disentitlement of deduction *u/s.* 11. The ITAT, however, after proper appreciation of the facts, held that the transactions have to be viewed individually as a person and not collectively. The debit balance standing in the name of the Managing Trustee in the books of the Trust, in the month of October was, therefore, held to be a violation *u/s.* 13(1)(c) and the Assessing Officer's action to deny exemption *u/s.* 11 was upheld.

7.2.4 The Assessing Officers while verifying the transactions between the NPO and that of the persons specified *u/s.* 13(3) should not confine themselves to the Balance Sheet figures. The copies of the ledger folios of the specified persons as appearing in the books of the NPO has to be examined and even in a case of minor violation, should result in denial of exemption *u/s.* 11. Proviso to 13(2)(g) provides that the provisions of Section 13(1)(c) will come into play when the value of the property diverted to persons specified *u/s.* 13(3) exceeds Rs. 1000.

7.3.1 A Trust was running a group of Educational Institutions. The Trust was initially managed by members from two families. The Trust was thereafter bifurcated and members of one family took complete control over the affairs of the Trust. Due to certain arrangement, Educational Institutions along with land & building worth Rs. 37,83,27,858 were received as donation and taken to the corpus of the Trust. This corpus donation received in kind was claimed exempt *u/s.* 11(1)(d).

7.3.2 While examining the return of income it was found that an amount of Rs. 15.76 crores was shown as 'Advances for property'. On verification, it surfaced that the nomenclature of the outstanding being 'advance for property' was bogus and the amount was actually given as loan to the Managing Trustee. The audit report in Form No.10B did not disclose the Related Party Transactions. In order to camouflage the transaction as a property advance, an unregistered deed of agreement was produced expressing that the Trust intended to buy a property owned by the Managing Trustee for a consideration of Rs. 20 crores and an advance of Rs. 15.76 crores was paid to the Managing Trustee. On further verifications it transpired that the property intended to be sold by the Managing Trustee to the Trust was purchased by him at a cost of Rs. 3 crores and within a span of 15 months, the Managing Trustee was selling it to the Trust at a price of Rs. 20 crores. Therefore, the transactions were not found at arm's length and the genuineness of the agreement remained unsubstantiated. It was submitted by the assessee that the agreement ultimately did not fructify. It was found that the Managing Trustee on cancellation of the agreement did not return the entire sum immediately but the funds were refunded to the Trust in the subsequent years in piece meal. It was also found that the advance given was without adequate security or adequate interest. Since the transactions between the Trust and its Managing Trustee resulted in conferring undue benefit to a specified person, the provisions of sec.13(1)(c) became operational. Further, the amount of Rs. 15.76 crores was invested in a mode which violated the provisions of sec.13(1)(d). Therefore, exemption *u/s.* 11 was denied.

7.3.3 It was also found that the amount of Rs. 15,76,00,000 was lent to the Founder

and Managing Trustee without charging any interest. On the contrary, the Trust had paid an interest of Rs. 2,10,68,997 on a term loan of Rs. 28,14,19,366 obtained from various banks. By the diversion of funds to the interested persons free of interest, the Trust is overburdened with interest costs. The value of benefit passed on to the interested person was worked out at Rs. 38,74,151 @10% being the rate of interest paid by banks on deposits.

7.3.4 The corpus fund of Rs. 37,83,27,858 was received by the assessee during the year, in the form of donation of assets from 2 other Charitable Trusts. This receipt under the normal circumstances was eligible for exemption *u/s.* 11(1)(d). But, it was held that the assessee was ineligible for exemption *u/s.* 11 due to violations of provisions of Sections 13(1)(c) and 13(1)(d). When Section 11 becomes inoperative, any income of the Trust becomes taxable and such income includes the corpus donation which is otherwise exempt *u/s* 11(1)(d). Therefore, the assessee was not found eligible for exemption of Rs. 37,83,27,858 being the donation received *u/s.* 11(1)(d).

7.3.5 A question arises, what would be the quantum of income that needs to be brought to tax, by such violations. This issue has been answered by the High Court of Andhra Pradesh in the case of Chairman, Andhra Pradesh Welfare Board *vs.* CIT reported in 12 Taxmann 242 (AP). It held that:

> *"….where a Public Welfare Fund, which has been constituted for the purpose of utilising the funds collected for the welfare of the people in different spheres, has been made to pay tax on the voluntary contributions received by it because the persons concerned with the administering of the fund Utilised a small part of the fund for extraneous purposes not connected with the objects and purposes of the fund. The result is that not only that small portion of the fund which was Utilised for such purposes out of the contributions but the entire contributions received by the fund became taxable in the hands of the fund and the fund has been assessed to tax on an income of ₹ 5,03,380 for the assessment year 1971–72 and on ₹ 7,91,770 for the assessment year 1972–73. If only the voluntary contributions had been Utilised strictly for charitable purposes for which they were intended, the Welfare Fund would not have been liable to pay any tax. By reason of the misapplication of a portion of the fund, a heavy tax liability has been imposed upon the fund. We hope and trust that, in future at least, care is taken to see that the contributions to the fund are strictly applied for the purposes for which they are intended and the fund is not put to the necessity of paying any tax on such contributions."*

7.4.1 A charitable Trust was running an educational institution enjoying the benefit of sec.10(23C)(vi) based on the approval granted by the CCIT. On verification of the return of income for the AY 2011–12, it surfaced that an amount of Rs. 172 crores was held as Fixed Deposits. The income of the Trust through the years was hovering around Rs. 20 crores to Rs. 30 crores per annum and a surplus of Rs. 172 crores held as fixed deposit amply indicated that the Trust was not applying its income in accordance to the third proviso of sec.10(23C) of the Act.

7.4.2 On enquiry it was found that the assessee had been accumulating unutilised income through the years without applying the same subsequently. Based on the evidences gathered during the source of such enquiry, it was established that the Trust was habitual in its failure to apply income. In all the years starting from AY 1999–2000, the assessee Trust had applied around 30% of its income in the respective years and the balance was automatically accumulated as per third proviso to sec.10(23C).

7.4.3 The same proviso also envisages that such accumulated sums has to be applied within a period of 5 years (10 years till AY 2001–02) from the end of the relevant Financial year. However, the enquiry revealed that such accumulations were never Utilised in future within the stipulated period or even after the lapse of 5 yeaRs. The assessee had been consistently failing to comply to third proviso to sec.10(23C) and based on the enquiry report the CCIT withdrew the approval earlier granted *u/s.* 10(23C)(vi) w.e.f. AY 2003–04.

7.4.4 The assessments for all the years from AY 2006–07 were reopened. Since the approval *u/s.* 10(23C)(vi) no longer subsisted, the assessee filed returns of income making an alternate claim of exemption *u/s.*11. The accumulations were claimed exempt *u/s.*11(2). On verification of the financials and the accounts, it was found that in certain years, advance was paid towards purchase of property, which was treated as application of income. Further, in the year when such advances for purchase of property culminated in acquisition of a capital asset, the entry in the fixed asset schedule of the Balance Sheet was also treated as application of income. Thus there was duplicate claim of application of income once in the form of advance and again at the time of acquisition, which had to be rejected.

7.4.5 Since the approval *u/s.* 10(23C)(vi) was rescinded, the assessee was found ineligible for exemption. The alternate claim *u/s.* 11 was extended since the Trust was registered *u/s.* 12A(a). However, the benefit claimed *u/s.* 11(2) was denied since the Form No.10 filed did not specify the purpose of accumulation. The request for condonation of delay in filing Form No.10 *u/s.* 119(2)(b) was also rejected and the surplus for the respective years being the difference between the unutilised or unapplied income and 15% of the income was brought to tax. The accumulated surplus of the preceding years which remained unutilised subsequently within the stipulated period was brought to tax *u/s.* 11(3)(c). The assessments were therefore concluded in all the years starting from AY 2006–07 wherein the benefit of exemption *u/s.* 11(2) was denied. The total income brought to tax through the years exceeded Rs. 150 crores. The petition seeking waiver of interest *u/s.* 234A/B/C was rejected by the Board.

7.5.1 A Trust was running multiple schools at various places. The objects of the Trust were directed at running of schools and also operating and maintenance of a Marriage Hall. In the course of scrutiny proceedings it was found that the rental income of the Marriage Hall was bifurcated into two portions. A sum of Rs. 20,000 was received as rent per day and the Trust billed Rs. 5,000 as rent and the balance Rs. 15,000 as corpus donation. The bifurcation was undertaken with a specific purpose to ensure that the quantum of receipts in the nature of business does not exceed Rs. 10 lakhs which otherwise would result in invoking proviso to sec.2(15).

7.5.2 The assessee contended that running of the educational institutions was its primary objective and operations of Marriage Hall was incidental and only helped in feeding the charity being education. The contentions of the assessee had to be rejected since the business of running the Marriage Hall was, as per the objects of the Trust, a principal purpose. The Marriage Hall was created by the Trust out of its own funds and, therefore, the property being the business of running the Marriage Hall was not 'held under Trust' but 'held by the Trust'. Since, one of the objectives was an object of general public utility, the Trust was found to get categorized in the last and residual category of charitable purpose and did not belong to the main limbs of charity *u/s.* 2(15). Further, the corpus donations were found irretrievably attached to the renting of marriage hall. In order to be eligible for exemption *u/s.* 11(1)(d), the donation has to be 'voluntary' in nature. Since the receipt of Rs. 15,000 per day was reciprocated by letting of marriage hall, the voluntary nature got lost and therefore, the entire sum of Rs. 20,000 was treated as income derived from the property of the Trust. Since

the quantum of total receipts exceeded Rs. 10 lakhs, the proviso to sec.2(15) r.w.s. 13(8) was invoked thereby denying complete deduction u/s. 11. The assessee's appeal was allowed by the CIT(A) on a finding that the operations of the marriage hall was incidental to the charitable activity of the Trust. However, the ITAT upheld the position as taken by the Assessing Officer on all counts and held as under:

"6. We have heard both the parties and perused the material on record. The issue before us is whether, on the facts and circumstances of the case and having regard to the terms of the Trust Deed, it can be said that the activities carried on by the assessee in the form of running of community hall, viz. "CK Marriage Halll" was itself held under the Trust. For this purpose, it is proper to go through the objects for which assessee-Trust is formed. The objects for which the Trust established are enumerated in Trust Deed in Clause-5.

The Objects of the Trust are:

a. …….

g. To construct a community hall for letting out to all peoples irrespective of casts, creed or religion for a nominal rent without making any point.

7. It is to be noted that Section 11(1) of the Act grants exemption to the income derived from property held under trust wholly for charitable or religious purposes, to the extent to which such income is applied to such purposes in India. There is no exhaustive definition of the words "property held under trust" in the Act; however, sub-section (4) says that for the purposes of Section 11, the words "Property held under trust" "includes a business undertaking so held".

…….

8. Thus, if a property is held under trust, and such property is a business, the case would fall u/s. 11(4) and not u/s. 11(4A) of the Act. Section 11(4A) of the Act would apply only to a case where the business is not held under trust. Thus, there is difference between property or business held under trust and business carried on by or on behalf of the trust.

9. This distinction was recognized by the Supreme Court in the case of Addl. CIT vs. Surat Art Silk Cloth Manufacturers Association (1980) 121 ITR 1 wherein it was observed that if a business undertaking is held under trust for a charitable purpose, the income there from would be entitled to the exemption u/s. 11(1) of the Act. In the present case, the finding of the CIT(A) is that running of community Hall was incidental to the object of the trust, it was not business commenced/ carried on by the assessee. Though the business was commenced by the trust and it was carried on by the Trust after its formation, it cannot be said to constitute property held under trust. u/s. 11(4), it is only the business which is held under the trust that would enjoy exemption in respect of its income u/s. 11(1) of the I.T. Act and there is a distinction between the objects of a trust and the powers given to the trustees to effectuate the purpose of the trust. Though the objects of the trust were charitable, they were mere powers conferred upon the trustees to carry on the business and the profits from such business would benefit the charitable objects. The exemption u/s. 11 cannot be granted on the reason that the business itself was not in existence at the time of formation of the trust and the property held under trust at

the time of formation of the trust was not spelt out in the Trust Deed of the assessee. The running of " Community Hall" was not at all in existence at the time of formation of the trust so as to say that the business is property held under trust. Thus, the activities relating to running of "Community Hall" was not even in the contemplation of the Trust Deed on the basis of which the Society is formed and, therefore, could not have been settled upon trust. The business carried on behalf of a trust rather indicates a business which is not held in trust, than a business of the trust run by the assessee. In this case, the activities viz., running of community hall, was carried on by the assessee for and on behalf of the trust and it was not business held under trust. Section 11(1) of the Act confers exemption from tax only where the property is itself held under trust or other legal obligation; it does not apply to cases where a trust or legal obligation is not created on any property but only the income derived for a charitable or religious purpose. Surplus funds of a trust, which was claimed to be exempt on the footing that it was property held under trust within the meaning of sec. 11(1) of the Act, was not property held under trust since the property from which the surplus was generated was itself not held under trust. In other words, merely carrying on business for and on behalf of the trust and applying the profits of the same for the object of the trust does not entitle for exemption u/s. 11(4) of the Act unless the business is incidental to the attainment of the objects of the trust.

10. We now proceed to consider the question whether the said activities carried on by the assessee were incidental to the attainment of the objects of the trust. We fail to see any connection between the activities relating to running of "Community Hall" was carried on and the attainment of the objects of the trust. The mere fact that whole or some part of the income from running of "Community Hall" is used for charitable purposes would not render the business itself being considered as incidental to the attainment of the objects. We are in agreement with the Department that the application of income generated by the business is not relevant consideration and what is relevant is whether the activity is so inextricably connected or linked with the objects of the trust that it could be considered as incidental to those objectives.

11. It was contended by the Ld. AR that the surplus funds generated from the running of "Community Hall" was spent towards charitable activities and therefore, the assessee is entitled for exemption u/s. 11(4) of the I.T. Act. We are unable to accept this contention. Initially, the assessee carried on the business itself which is not at all property held under trust. This activity is a business activity and the provisions of Section 11(4A) of the Act is applicable.

12. It was contended that if the profits of the business carried on by the trust are Utilised by the trust for the purposes of achieving the objectives of the trust, then the business should be considered to be incidental to the attainment of the objects of the trust as observed by the Supreme Court in the case of ACIT vs. Thanthi Trust (2001) 247 ITR 785 which is as under: "As it stands, all that it requires for the business income of a trust or institution to be exempt is

that the business should be incidental to the attainment of objectives of the trust or institution. A business whose income is Utilised by the trust or the institution for the purposes of achieving the objectives of the trust …….In any event, if there be any ambiguity in the language employed, the provision must be construed in a manner that benefits the assessee".

13. Prima facie the above observation would appear to support the assessee's case in the sense that even if running of "Community Hall" is held not to constitute a business held under trust, but only as a business carried on by or on behalf of the trust, so long as the profits generated by it are applied for the charitable objects of the trust, the condition imposed u/s. 11(4A) of the Act should be held to be satisfied, entitling the trust to the tax exemption.

14. In our opinion, these observations have to be understood in the light of the facts before the Supreme Court in the case of Thanthi Trust (supra), wherein the trust carried on the business of a newspaper and that business itself was held under trust. The charitable object of the trust was the imparting of education which falls u/s. 2(15) of the Act. The newspaper business was incidental to the attainment of the object of the trust, namely that of imparting education and the profits of the newspaper business are Utilised by the trust for achieving the object of imparting education. In this case, there is no such nexus between the activities carried on and the objects of the assessee that can constitute an activity incidental to the attainment of the objects, namely, to promote cause of charity, mission activities, welfare, employment, diffusion of useful knowledge, upliftment and education and to create an awareness of self-reliance among the members of the public etc. We are therefore, of the opinion that the observations of the Supreme Court must be understood and appreciated in the background of the fact in that case and should not be extended indiscriminately to all cases. Being so, we are inclined to hold that the assessee is not entitled for any exemption u/s. 11 of the I.T. Act.

15. In this case, it is brought on record by the AO that the assessee collected ₹11,28,000 as corpus donation from 93 persons who performed functions at "CK Marriage Hall". In addition to this, ₹4,70,000 was rent for utilizing the facilities of "CK Marriage Hall" by 53 persons, totaling is ₹15,98,000. As against this, in guise of corpus donation collected ₹11,28,000 from the persons, who have performed the functions in the "CK Marriage Hall". That amount of ₹11,28,000 cannot be considered as corpus donation instead it should be a rental income. On enquiry by assessing officer, it was proved that the persons who paid rent of community hall and who paid the corpus donation were same. This is an act of quid pro for hiring the hall and no question of voluntary contribution in this payment. It is also to be noted that the dates exhibited in both cases were same. Being so, the provisions of sec.2(15) of the Act is squarely applicable as total receipts of rent from community hall exceeds ₹10 lakhs, and we do not find any infirmity in the order of AO in rejecting the claim of exemption u/s. 11 of the Act. Accordingly, the order of Ld.CIT(A) is reversed and the order of AO is restored.

16. In the result, the appeal of Revenue is allowed."

7.6.1 M Society was created with a purpose to create awareness on various topics to the public. It claimed *u/s.* 11 on the pretext that its activity belongs to the main limb of charity being 'education'. It was found that the objects of the Society amongst various objects included a few objects which was claimed as educational, which were as under:

a. To stimulate thought and efforts towards the promotion and development of the management education movement in India more particularly in South India through lectures, conferences seminars and other media.

b. To make available the benefits of its management educational activities and facilities to the public at large, without restricting the same only to the Members of the Association.

c. To publish journals, newsletters, and such other publications on developments and trends in Management Education.

d. To maintain liaison with all organisations interested in Management Education such as Trade Associations, Chambers of Commerce, All India Management Association (AIMA), and its Regional Councils, local management associations and similar professional bodies.

7.6.2 The sense in which the word 'education' has been used in Section 2(15) is the systematic instruction, schooling or training given to the young in preparation for the work of life. It also connotes the whole course of scholastic instruction which a person has received. The issue with regard to the procedure employed in dissemination of knowledge through Lectures, Seminars and Workshops conducted by the Association was found to be dealt by the High Court of Rajasthan in the case of CIT V. Jodhpur Chartered Accountants Society reported in 258 ITR 548. Though the High Court had decided the issue in favour of the assessee and against the revenue, and held the Society to be "charitable", it had nevertheless categorized the purpose of charity to be of "General Public Utility "and not "Educational purpose". It held as under:

> *"The assessee was a society of Chartered Accounts registered under Societies Act, its predominant object being dissemination of knowledge and education of commercial and tax laws for the benefit of general public and to hold seminars etc., for the purpose. The facts of such seminars etc., were available to public at large. In the situation of explosion in population, the vast changes brought by the scientific technology and other developments, more particularly, the universal concept of globalisation, new trends in the world order to meet the ever growing challenges to organising seminars, conferences and workshops to educate the people of commercial laws, tax laws, auditing, accounting, direct and indirect taxes are of great general public utility, at least to a Section of people falling in the category of charitable institution. "*

7.6.3 The scheme deployed by the assessee was not found to be for charitable purpose with the object of "Education" since it did not conduct any formal educational courses, nor was it affiliated to or registered with any authority. The Delhi High court in the case of DIT *vs.* The Institute of Chartered Accountants of India, reported in 347 ITR 86 found ICAI to have always been an institution set up, inter alia, for imparting formal education and for testing proficiency for entry to the profession of chartered accountants. The Institute imparted formal education in accountancy and connected subjects in an organized and systematic manner. The Institute was accountable as per the provisions of the Act establishing it and also had disciplinary control over the students who were required to be registered with it in the first place and who appeared at the exams being held by

the institute. Hence, the example of the Institute of Chartered Accountants of India was not apposite and the assessee was not at all found comparable to the said Institute.

7.6.4 The Association had thrived towards achieving the principal object to simulate thought and efforts towards efficiency in management through lectures, seminars, conferences and other media. The activities and the source of revenue was only by its activity of conducting workshops, talks, certificate courses, industrial visits, personality development, convention, video conferences, corporate training programs to improve skills etc. None of these activities undertaken comprised any of the three indices (formal education, accountability and control) as described above. Hence it was not held to be an educational institution. However, the assessee society was found to be a charitable organisation with the charitable purpose being the "Object of General Public Utility'.

7.6.5 The sums received by the society were the fees charged from the participants. The concept of charity is essentially pivoted to "voluntary" nature in the receipts and not to those resulting in reciprocation. The TDS certificates issued by the participants or the institutions which engaged the services of the Society uniformly categorized the nature of payment to be towards "Fees for Professional/ Technical services". The list of events, major & minor organized by the Association and the description of the programme, signified that the services rendered were in the nature of business. It was found that the transactions were under the ambit of the *proviso* to Sec.2(15) of the Act, which stipulated as under:

> *"Provided that the advancement of any other object of general public utility shall not be a charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity."*

Therefore, the transactions squarely fall under the ambit of the *proviso* to Sec.2(15).

7.6.6 Since the *proviso* to Section 2(15) got invoked, the provisions of Section 11 & 12 become inoperative. The entire earnings were held as income of the society. While the revenue expenditure corresponding to such income earning activity was allowed, the expenses of capital nature and expenditure not connected to the income earning activity were not eligible to be allowed as deduction. Therefore, the exemption *u/s*. 11 was denied. Further, Section 13(8) prohibits applicability of Section 11 & 12 in respect of *any* income of the society and is not restricted to the business activity of the Society. Therefore, the surplus derived by the Society was entirely brought to taxation.

7.7.1 A group of 7 firms were running coaching classes providing specialised coaching to students of 9th to 12th standard, besides vocational courses. It was not running a proper school but providing extra tuition classes to the students studying in regular schools. It was observed that though the number of students in this coaching institute was very high, the income returned by the institution was meager. A survey *u/s* 133A was conducted and the books of accounts of various firms were found available in the form of computer print outs/ bound red books, which showed nominal incomes. However, the transactions for the current year were found recorded in rough exercise books in the nature of cash book and ledger for each firm, but these were not regular books of accounts. A number of items in these rough cash book were not ledgerised. Although, the total of cash balances of all the concerns as per these rough cash books came to more than Rs. 1.19 Crores, the cash available at the business premises, was

a nominal amount. There was absolutely no explanation as to why such huge cash would be kept as cash on hand, despite the fact that all the firms were operating their bank accounts regularly. It was stated by one of the partners that cash was lying partly at residence and partly in bank lockers. Further, as per these rough books of accounts, the total profits of all the firms till the date of action worked out to more than Rs. 1.16 Crores, whereas the profits disclosed by all the firms during all the preceding years put together, was not even one tenth of this. The advance tax payments for the current year were very nominal, and as per these the total income of all the firms put together the group would not be more than Rs. 2 to 3 lac.

7.7.2 The only conclusion, therefore, was that the rough exercise books showed the real incomes of these firms, but these were not meant to be disclosed to the department. It emerged that the assessee group had been concealing its income during past assessment years by rewriting the books of accounts and fee registers after the close of the relevant financial years. It also became clear that during the currency of the FY these firms maintained regular accounts but these were not meant to be disclosed to the department. Therefore, the survey was converted into a search. It finally emerged that, the assessees were suppressing receipts by replacing the rough books of accounts maintained during the course of the year, with rewritten "proper" books of accounts, prepared after the close of the year. The disclosed Gross Profit rates varied from 11.9% to 35.3%. However, the gross profit rates as per books found varied from 70% to 82.58%. It was later found on enquiry that after the completion of the year, the assessees were replacing the fee receipt registers prepared during the course of the year, by totally different fee receipt registers where the gross fee receipts were suppressed considerably. It was found that these fee receipt registers meant for being produced before the department, were prepared at a stretch. Examination showed that the receipt numbers issued to the students of the same concern were not always sequential. This gave the clue that though the students might have been issued genuine fee receipts at the time of actual receipt of fees, the picture presented before the department would be a make-believes picture created with the help of fabricated fee receipts registers, prepared at will after the close of the accounting period. Names and addresses of some students were obtained and their statements recorded, and the fee receipts produced by them were compared with the figure of fees payment shown in the register. It turned out that there was suppression of fees ranging between Rs. 800 to Rs. 6000/- per student. During the course of search cash totaling Rs. 1.19 crores stashed away in bank lockers, and cupboards at the residence, was found.

7.7.3 The other modus for concealing income adopted by the assessee was that the teachers were paid a salary lower than the figure debited in the books of accounts. Statements of some of the teachers were recorded to establish this part of concealment. In fact, it came to light that one of the teachers was providing honorary service and was charging no remuneration at all from the assessee. However, the assessee had debited a salary of around Rs. 25,000/- per month in the name of this teacher also.

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